# RULES FOR THE FEDERAL TAX TREATMENT OF FRINGE BENEFITS

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## HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

**H.R. 3525**

TO PROVIDE PERMANENT RULES FOR THE
TAX TREATMENT OF FRINGE BENEFITS

AUGUST 1, 1983

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# RULES FOR THE FEDERAL TAX TREATMENT OF FRINGE BENEFITS

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## MONDAY, AUGUST 1, 1983

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
*Washington, D.C.*

The subcommittee met at 10:10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

[Press release of Wednesday, July 13, 1983]

Hon. Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, a Public Hearing on H.R. 3525, Legislation Providing Permanent Rules for the Federal Tax Treatment of Fringe Benefits, on Monday, August 1, 1983

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman of the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, U.S. House of Representatives, announces a public hearing on H.R. 3525, the Permanent Tax Treatment of Fringe Benefits Act of 1983, legislation providing permanent rules for the federal tax treatment of fringe benefits. The hearing will occur on Monday, August 1, 1983, beginning at 10:00 a.m. in Room 1100 Longworth House Office Building, the Committee's main hearing room.

In announcing this hearing, Chairman Stark noted that "a further extension of the expiring moratorium on the issuance of fringe benefit regulations would only perpetuate the uncertainty and inconsistencies in the current administration of the tax laws relating to nonstatutory fringe benefits. In the interest of equity among taxpayers and concern for the negative impact on the voluntary nature of our tax system, it is incumbent upon the Congress to attempt to clarify the tax treatment of nonstatutory fringe benefits. The introduction of H.R. 3525 and the prompt scheduling of this hearing reflect a commitment to resolve this issue on a permanent basis this year."

The lead-off witnesses are expected to be the Honorable John E. Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury, and the Honorable Roscoe Egger, Commissioner of the Internal Revenue Service.

### FRAMEWORK FOR DISCUSSION

The Subcommittee specifically invites testimony on H.R. 3525, introduced on July 12, 1983 by Chairman Stark and the Honorable Barber B. Conable, Jr., Ranking Minority Member of the Committee on Ways and Means. As indicated in Chairman Stark's statement upon introduction of this bill, H.R. 3525 is intended to provide a permanent solution to the extremely difficult problems created by the disparate tax treatment of cash and in-kind compensation. The approach adopted by this bill represents an attempt to accommodate many existing industry practices for the provision of fringe benefits in recognition of the perception and expectation that those benefits are nontaxable. Therefore, the bill creates a number of new categories of fringe benefits that would be excluded from gross income under certain conditions (for a further discussion of the rationale and technical explanation of the bill see the Congressional Record, July 12, 1983, page H 5056). A description of the bill is also available from the Subcommittee on Select Revenue Measures, Committee on Ways and Means, 1136 Longworth Building, Washington, D.C. 20515 ((202) 225-9710).

Witnesses are asked to limit their testimony to H.R. 3525 and the specific issues addressed in this press release. Furthermore, the Subcommittee wishes to emphasize that it will not take testimony at this time on unrelated fringe benefit issues or on fringe benefits whose tax treatment is expressly provided for by other sections of the Internal Revenue Code. In addition, the Subcommittee requests that any witness addressing a specific fringe benefit should identify the aggregate value and cost of the particular fringe benefit for the most recent taxable year, and the terms on which is is offered.

Further, in developing H.R. 3525, it appeared that the ability of a taxpayer participating in a cafeteria plan (Code section 125 plan) to choose among cash, other taxable, and statutorily-excluded fringe benefits could contribute to confusion among taxpayers as to what benefits must be included in income, and hence, to a growing compliance problem. The Subcommittee is aware that some observers are also more generally concerned about the trend to provide in-kind fringe benefits in lieu of cash compensation in the context of cafeteria plans. This concern appears to be magnified to the extent that these plans might be funded through the reduction of each participating employee's salary. There is the further concern that these plans could be designed to maximize their attractiveness to, and hence, utilization by, more highly compensated employees, to the detriment of low paid employees. While the primary focus of this hearing is H.R. 3525, the Subcommittee also invites testimony on these issues.

*Details for submission of requests to be heard*

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard in writing no later than Tuesday, July 26, 1983, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements to the full Committee office, room 1102 Longworth House Office Buiding, no later than close of business, Friday, July 29, 1983. Failure to comply with this requirement may result in the witnesses being denied the opportunity to testify in person.

Each statement to be presented to the Subcommittee or any written statement submitted for the printed record must contain the following information:

(1) The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached; (2) a list of any clients or persons, or any organization for whom the witness appears; and (3) a topical outline or summary of comments and recommendations.

*Written statements in lieu of personal appearance*

Persons submitting a written statement in lieu of a personal appearance should submit at least six (6) copies of their statement by the close of business, Monday, August 15, 1983, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may submit additional copies for this purpose if provided to the full Committee office before the hearing begins.

Chairman **Stark**. The Subcommittee on Select Revenue Measures will begin the most popular hearing of 1983, the consideration of H.R. 3525 introduced by myself and Mr. Conable. H.R. 3525 provides permanent rules for the tax treatment of nonstatutory fringe benefits.

The Internal Revenue Code defines gross income broadly and includes all compensation for services. In practice, the broad definition of the code has not been followed and where compensation is paid in forms other than cash, its tax treatment has been resolved by a patchwork of statutory provisions, regulations and administrative rules.

Treatment of the so-called nonstatutory fringe benefits has been particularly troublesome. Since 1978, the Internal Revenue Service has been prevented by congressionally imposed moratoriums from issuing regulations relating to tax treatment of these benefits. The inability to resolve this issue stems from different accounting and valuation problems as well as the widely held perception that long established benefits should not be taxed.

Since 1975, numerous efforts have been made to provide permanent rules. I will not recount all the different attempts that have been made by the Treasury, this committee, this subcommittee, and a wide range of interested outside groups to solve this problem. Suffice it to say that this issue has remained unresolved for far too long.

The inability to resolve this issue has produced uncertainty, and inequitable treatment for similarly situated taxpayers. The most significant result of the failure to find a solution is the continuing erosion of the tax base, especially during a time of huge budget deficits. The Social Security trustees estimated that fringe benefits have grown from 5.4 percent of total compensation in 1951 to 16.3 percent in 1981, and could reach as high as 38.3 percent by the end of the century.

During the last decade, while wages experienced a 115-percent increase, fringe benefits were up 161 percent. Lance Tane, an analyst for the Wyatt Co., said that fringe benefits used to be the condiments of any pay package, but suddenly they are becoming the meat and potatoes.

I am committed to resolving this issue this year. I want to make it very clear that insofar as the Chair is concerned, under no circumstances will I support any further extension of the moratorium. If the Treasury is unwilling to take a stand and a position, it ends up in the Treasury's lap and they can take the heat from all of the friends that I have who are enjoying fringe benefits. Let the Treasury make the regulations; this is the last year that this Chair is going to support an extension of the moratorium.

The Permanent Tax Treatment of Fringe Benefits Act of 1983 is an attempt to bring fair and workable rules to this area. It provides generous rules for all benefits offered to employees on favorable terms where the goods or services are those provided to customers in the normal course of the trade or business of the employer. It leaves intact all benefits currently exempted from taxation by statute and the thrust of the bill is to limit the growing practice of providing nontaxable benefits as compensation rather than taxable consideration.

This bill attempts to strike a delicate balance between the historic fringes directly related to an individual's employment status which may be deserving of special treatment and those fringes which can be more easily valued and whose benefits totally accrue to the employee.

The bill's treatment of goods or services that an employer provides an employee through reciprocal arrangements are of particular concern to certain groups. In striking this balance, I want the witnesses to know that the Chair remains flexible.

I hope that the testimony today will point out problems that exist with the rules we have laid out in H.R. 3525 and not just the extent of the greed of the groups that will be testifying today.

I think all of you have to remember that there are millions of Americans who would happily pay taxes to receive some of the fringe benefits that the people you represent now are receiving. You know it and the members of this subcommittee know it.

I know that the committee will reexamine many of the rules in light of today's testimony, we are looking for constructive and helpful testimony. We have heard the criticism of the problems that it will bring to your employees for the past 5 or 6 years.

The Chair is disappointed that the administration was unable to testify or has declined to testify today. The Treasury presented testimony to the Senate Finance Commitee on June 22, 1983; it is not a matter of feeling slighted, but it is a matter of fact that at that time, the statement was made by Assistant Secretary Chapoton that the issue of proper tax treatment of nonstatutory fringe benefits has been a matter of great concern to the Treasury Department for many years.

He stated at that hearing that this places employers who pay cash wages at a disadvantage from employers who do not and erodes the tax base, encourages uneconomic and complicated transactions and reduces public confidence in the fairness of the tax system.

In the absence of the Treasury's testimony today, I would ask unanimous consent that the Treasury's testimony of June 22, 1983, be made a part of the record of this hearing.

[The information follows:]

## STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY [1]

Mr. Chairman and members of the committee, I am pleased to appear before you today to present the Treasury Department's views on S. 640, which would limit the amount of the exclusion from the gross income of employees for employer contributions to health plans, and on the tax treatment of fringe benefits in general.

### S. 640

*Background*

Under present law, an employee's gross income does not include contributions by the employer to health plans that provide compensation to employees for personal injuries or sickness. The exclusion from the employee's income of employer payments to health care plans encourages employers to provide and employees to accept a portion of compensation in the form of health insurance. Employees are benefited by the exclusion because they do not have to pay income or social security taxes on the value of the health insurance. Employers benefit because it costs them less to compensate employees since they do not have to pay unemployment taxes or the employer's share of social security taxes on the value of the insurance; employers also may be able to reduce the amount of pretax compensation paid, since the employee receives a greater after-tax share of the pretax compensation.

Excluding employer contributions to health plans from gross income creates an inequity between individuals covered by employer health plans and those who are not so covered. The latter group must pay for their health care with after-tax dollars, while the health care of the former group is provided with pretax dollars. In addition, the exclusion encourages employees to receive large amounts of their compensation in the form of tax-free health insurance. This has led to a significant increase in the amount of compensation that is not subject to tax and, therefore, to a substantial loss of Federal revenues, including revenues for funding social security benefits. The costs of this exclusion, both in terms of foregone Federal revenues and the inequities created between various taxpayers, have been accepted until now as the price paid to accomplish the important social goal of providing individuals with adequate health insurance protection.

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[1] This statement was presented at a hearing before the Senate Committee on Finance on June 22, 1983.

The tax benefit attributable to receiving compensation in the form of tax-free health care premiums rather than cash is so substantial that employers are encouraged to provide, and employees are encouraged to accept, extraordinarily generous health insurance coverage, often with no internal controls on costs and utilization of services by the employee. Such packages provide insurance coverage far in excess of the amount reasonably needed to protect an employee from financial hardship in the event of personal injury or sickness.

The proliferation of overly comprehensive employer-paid health care plans without internal cost controls is a contributing factor in the rapid increase in health care costs in recent years. Some insurance plans are so generous that employees bear little, if any, of the cost of doctors' visits or hospital services. Without any costs imposed on them, the employees tend to overuse doctor and hospital services and medical tests. Overuse increases both the cost of each service and the number of services utilized by each individual. The result is an increase in health care costs.

This Administration supports the principle that individuals should be encouraged to obtain adequate health insurance. However, a careful examination of the exclusion provided for employer contributions to health care plans indicates it is being used to provide much more than adequate health insurance. The purchase of excessive amounts of health insurance has had detrimental effects on health care costs. For this reason, the Administration has proposed in its fiscal year 1984 budget to limit the exclusion from income for employer contributions to health plans to $175 per month for family coverage and $70 per month for individual coverage. These levels should permit employees to obtain adequate insurance coverage tax-free, while requiring them to bear some of the costs of providing more comprehensive insurance plans.

S. 640 is the bill introduced by Senator Dole at the Administration's request to enact the proposed limits on the exclusion for employer contributions to health plans for employees. For 1984, as mentioned, these limits are $175 per month for family coverage or $70 per month for individual coverage for each employee. For years after 1984, the monthly dollar limits will be adjusted to reflect changes in the Consumer Price Index. The amount of any excess employer contribution for a payroll period is treated as compensation paid to the employee in cash on the same date as other compensation for the same payroll period is paid or otherwise included in the employee's income. Thus, the normal rules relating to withholding and payroll taxes will apply to the amount of any excess employer contributions.

The amount of an employer's contributions to a health plan with respect to an employee is defined as the cost of coverage of the employee under the plan reduced by any contributions made by the employee for such coverage. The cost of coverage of employees under a plan is determined separately for family coverage and individual coverage. For a particular employee the cost of coverage is the average cost per employee of providing coverage for all employees having the same type of coverage (i.e., individual or family coverage).

In some cases, an employer will know in advance the exact cost of providing coverage for his employees and can determine the actual amount of excess employer contributions, if any, prior to the beginning of any payroll period. For example, an employer that purchases an insurance policy for an employee for a premium that is fixed in advance will be able to determine exactly what his employer contributions will be for the term of the policy. However, in many instances, employers do not know the exact cost of providing coverage for their employees until after the close of a payroll period. For example, an employer may be self-insured or may pay premiums that are retroactively adjusted based on the experience of the insurer with his employees. In order to avoid the confusion and hardship that would occur if retroactive changes were made in an employee's gross income for a payroll period, S. 640 provides that where the exact cost of coverage is not fixed in advance, the amount of an employee's income due to excess employer contributions will be fixed by the employer's estimate, made prior to the payroll period, of the cost of providing coverage. The employee's income will not be changed to reflect actual costs determined later, even if the actual cost of providing coverage turns out to be substantially higher or lower than the estimate. In cases where the employer's estimate is not reasonable, a penalty is imposed on the employer.

In order to approximate the premiums charged to an employer who purchases health insurance for employees, the cost of providing coverage under a self-insured plan is defined as the liability incurred for benefit payments under the plan plus all other costs, including administrative costs, incurred with repsect to the plan. For purposes of assisting employers of self-insured plans in estimating the cost of providing coverage, S. 640 allows the employer to assume that his administrative and other costs equal 7 percent of the liability he incurs for benefit payments under the plan. In addition, employers whose premiums are fixed in advance but fluctuate from year to year based on prior experience under the plan are allowed to use an average cost of coverage based on the employee's premiums for the preceding three years (adjusted to reflect changes in the cost of health insurance).

Multiemployer plans present an unusual situation, since the multiemployer plan rather than the employer actually provides the insurance coverage to the employee. This presents no problem in determining the employee's income from excess employer constributions. The multiemployer plan is required to determine the amount of excess employer contributions in the same manner as if it were an employer. That is, excess employer contributions will equal the excess of the cost of the health care coverage actually provided to the employee under the plan, reduced by any employee contributions, over the applicable monthly limit. This amount is to be reported by the multiemployer plan to the employee and is to be used by the employee in determining his actual income and social security tax liability for the year.

However, multiemployer plans do present technical difficulties for employers with respect to withholding and payroll taxes. Under a multiemployer plan, employees work for a number of different employers and each employer contributes a fixed amount to the plan to provide health care coverage for the employees. Contributions to the plan may be based on hours worked, pieces of work completed, weight of material moved, or some other measure of work done by the employees. The amount of contributions to the plan with respect to an individual employee bears no specific relationship to the employee's health care coverage under the plan. Furthermore, each employer has no knowledge of the coverage a particular employee has or the amount of contributions made with respect to the employee by other employers. In view of this lack of knowledge, it is not possible for an employer to determine the actual amount of excess employer contributions with respect to any individual employee. However, the employer's withholding and payroll tax obligations are based on the amount of the employee's income.

To resolve this technical problem, S. 640 provides a special rule for determining the amount of excess employer contributions for purposes of an employer's withholding and payroll tax obligations. Solely for these purposes, employers will treat a fraction of each contribution to the multiemployer plan as an excess employer contribution. This fraction, which will be determined by the multiemployer plan, is equal to that fraction of the average cost of coverage of all employees under the plan (reduced by the amount of any employee contributions) that exceeds the average of the monthly limits for family and individual coverage, weighted to reflect the relative amounts of family and individual coverage provided under the plan.

As representatives of the Department of Health and Human Services will describe in more detail, the Administration believes S. 640 will be a significant step toward controlling health care costs. For this reason, the Administration strongly urges rapid and favorable consideration of S. 640.

In connection with this proposal, the Administration believes that current proposals to provide health insurance for the unemployed should be financed by a reduction in the proposed limit on tax-free employer contributions to health plans for employees. For example, reducing the $175/$70 limit to $169/$68 would raise $300-400 million in additional revenue that could be used for health insurance for the unemployed.

## TAX TREATMENT OF FRINGE BENEFITS

Existing law relating to the taxation of fringe benefits can be divided into two parts. One part of the law deals with specific fringe benefits that Congress has determined should not be subject to taxation. Generally the reasons for excluding from income each of these specific fringe benefits—referred to as statutory fringe benefits—is to promote nontax social policies. Examples of statutory fringe benefits that promote such policies include employee contributions for pension plans, group term life insurance, health care plans, medical care reimbursements, educational assistance programs, and dependent care assistance programs.

Statutory fringe benefits promote nontax social policy by providing a Federal tax subsidy when the specified fringe benefit is substituted for taxable compensation.

An employee receiving a statutory fringe benefit is allowed to retain the full value of that benefit, rather than paying a percentage of that value to the Federal government as income and social security taxes. In effect, the Federal government is paying a portion of the employee's wages in order to encourage the employer to provide certain types of benefits to the employee. In addition, the employer's costs of compensating the employee are reduced by the amount of unemployment taxes and the employer's share of social security taxes that would have been imposed on cash wages.

The second part of current law on the tax treatment of fringe benefits relates to those fringe benefits that are not specifically addressed by statutory provisions. The taxability of these nonstatutory fringe benefits is currently governed by the general definition of gross income in section 61 of the Internal Revenue Code. Despite the fact that both Treasury regulations and numerous court decisions treat compensation paid in a form other than cash as includible in income under section 61, there is a public perception that a number of in-kind benefits received from an employer are not income and not taxable. It has not been possible to correct this erroneous perception because of the moratorium Congress has imposed on the issuance of Treasury regulations and rulings in this area. As a result, nonstatutory fringe benefits of substantial value are being excluded from income by employees.

### *Nonstatutory fringe benefits*

The issue of the proper tax treatment of nonstatutory fringe benefits has been a matter of great concern to the Treasury Department for many years. A "fringe benefit" may be defined generally as any personal benefit, other than cash paid as wages, which is furnished by an employer to an employee because of the employment relationship. For a variety of reasons, a large segment of the public believes that a wide variety of nonstatutory fringe benfits do not constitute income and are not taxable. The result of this perception is that employers and employees are arranging compensation packages providing for more and more compensation to be paid as nonstatutory fringe benefits in the mistaken belief that these benefits are not taxable. This erroneous treatment of certain nonstatutory fringe benefits places employers who pay cash wages at a disadvantage, erodes the tax base, encourages unecomonic and complicated transactions, and reduces public confidence in the fairness of the tax system. For these reasons, we believe it is extremely important that Congress address the question of the proper tax treatment of nonstatutory fringe benefits.

The Internal Revenue Code includes all income from whatever source derived, including compensation for services, in gross income. Treasury regulations specifically include in income compensation paid other than in cash, stating that if services are paid for in property or services, the fair market value of the property or services taken in payment must be included in income as compensation. Unfortunately, despite these clear statements of principle, the administration of the tax laws with respect to nonstatutory fringe benefits has required the drawing of some very fine distinctions. One such distinction is that between working conditions and compensation. An employee often receives a personal benefit from working conditions that an employer provides solely to facilitate the execution of the employee's duties. Technically the personal benefit obtained by the employee from working conditions might be considered part of the compensation received for his employment and thus includible in income. However, in administering the tax laws, the Internal Revenue Service has consistently taken the position that working conditions are not part of an employee's compensation and are not income to the employee. Distinctions between working conditions and compensation are not always clear. For example, prior to the enactment of section 119 which established certain objective criteria for determining which employer-provided meals and lodging are excludible from income, difficult questions were often raised about whether meals and lodging provided to employees were intended for the convenience of the employer, and therefore qualified as working conditions, or were intended as compensation.

Similarly, it is often difficult to determine whether a benefit provided by an employer to an employee is a gift or compensation. In 1921, the IRS announced that free personal railroad passes issued to employees were gifts rather than compensation. Based on this prior IRS position, many believe that free passes for airline travel are also gifts, and therefore nontaxable, despite the substantial benefit conferred on the employee by such passes.

The result of the existence of administrative exceptions to the statutory rule has been confusion about the taxability of a variety of in-kind benefits provided as compensation. Because of this confusion, the value of many nonstatutory fringe benefits is often being treated by employers and employees as not includible in the employee's income. When compensation is paid in fringe benefits, but the value of the fringe benefits is not included in income, employees with equal economic incomes are taxed unequally, depending on the relative amounts of cash and in-kind compensation each receives. In addition to causing losses of Federal income and social security revenues, this inequitable treatment of cash and in-kind compensation reduces public confidence in the fairness of the tax system.

During the early years of our income tax system, the use of fringe benefits to compensate employees was relatively rare and the marginal tax rates were quite low. Therefore, the adverse effects of employees' failing to include the value of fringe benefits in income was limited. However, as inflation has pushed many taxpayers into higher tax brackets, the increase in the value of nontaxable compensation, combined with the erroneous perception that certyain nonstatutory fringe benefits are nontaxable, has caused increased use of noncash compensation.

In the early 1970's, the IRS became concerned by the increasing use of fringe benefits by employers. A review of the matter led to the conclusion that the administratively drawn lines between taxable and nontaxable fringe benefits needed to be clarified. In 1975, the Treasury Department circulated a discussion draft of regulations that would have provided specific rules for determining when a nonstatutory fringe benefit was taxable. This discussion draft met with substantial opposition from the public. The discussion draft was withdrawn and, after much debate, Congress in October, 1978, imposed a moratorium on the issuance of new rulings or regulations relating to fringe benefits. This moratorium has been extended several times, and is currently scheduled to expire on December 31, 1983.

The effect of the moratorium has been the perpetuation of inconsistencies in the administration of the tax laws relating to nonstatutory fringe benefits. In the absence of uniform national guidelines, the tax treatment of particular fringe benefits is being determined by individual IRS agents at the local level. This practice results in inconsistent treatment from district to district and even from agent to agent. The inability of the Treasury Department to provide IRS agents and the public with a clear statement of the proper treatment of nonstatutory fringe benefits has left employers and employees confused at best. In addition, the moratorium has substantially strengthened the public perception that nonstatutory fringe benefits are not taxable under current law. Understandably, this perception results in very poor voluntary compliance in reporting by both employers and employees of the value of fringe benefits for income tax purposes. Voluntary compliance with reporting requirements is a key element of our tax system. Without it, the administrative costs of collection would be substantially increased.

In 1981, the prior administration, in response to the request of the Chairman of the House Ways and Means Committee, released another draft of regulations relating to nonstatutory fringe benefits. The 1981 draft again met with public opposition and an extension of the Congressional moratorium.

In view of this recent history, we have concluded that it is not possible for the Treasury Department to clarify the tax status of nonstatutory fringe benefits without legislative action. Legislative action is needed to provide clarification because there are a number of fringe benefits that have been assumed by the public to be nontaxable for a long period of time but which cannot be excluded from gross income by regulation. The primary examples of such fringe benefits are airline passes, tuition reimbursements, and merchandise discounts (other than discounts having a de minimis value). Because the perception of nontaxability of these benefits has been allowed to persist for a long period of time, resistance to clarification that such benefits are includible in income under existing law is substantial. Since exclusions of these benefits from income would be inconsistent with existing statutory provisions, it will not be possible for us to develop a regulatory fringe benefit proposal that will not generate substantial controversy. As the repeated extension of the moratorium indicates, Congress considers such controversy to be unacceptable. Therefore, we would like to discuss today some alternatives that Congress might consider in deciding how to clarify the tax treatment of fringe benefits.

One approach that Congress might take to resolving the issue of the taxability of fringe benefits would be to provide statutory exclusions for those nonstatutory fringe benefits which the public has considered nontaxable for a substantial period of time. While this approach avoids controversy, it would be a substantial departure from the prior Congressional practice of providing statutory exclusions for certain fringe benefits to promote desirable social policies. We see no desirable social policy that would be promoted by excluding from income the value of fringe benefits such as airline passes, tuition remission, or store discounts. Exclusion of such benefits would simply grant preferred tax treatment to employees in certain industries and professions.

Furthermore, we are concerned that any list of exclusions from income of current nonstatutory fringe benefits would become so comprehensive that it would not only permit but encourage greater use of fringe benefits to provide tax-free compensation. The result of enacting such broad legislation would be aggravation of the existing problems of inequitable treatment of taxpayers with equivalent economic income, loss of Federal revenue, and erosion of public confidence in the tax system. Legislation that explicitly excluded some existing nonstatutory fringe benefits might be preferable to an extension of the present moratorium on fringe benefits if the list of excluded benefits were narrowly drawn, or possibly if a low dollar limit were placed on the total amount that could be excluded under this new class of statutorily-sanctioned fringe benefits.

As alternatives to totally excluding certain nonstatutory fringe benefits from taxation altogether, we suggest that consideration might be given to addressing two elements of past fringe benefit proposals that have caused concern—the difficulties of determining fair market value and the perceived hardship imposed on employees when they must obtain cash to pay taxes on the value of in-kind benefits that cannot be converted into cash.

It is true that there are many cases in which the fair market value of a fringe benefit is difficult to determine. We believe that this difficulty justifies the development of either administrative or statutory guidelines for approximating the fair market value of fringe benefits or alternative methods of assigning a value to fringe benefits. In valuing a fringe benefit, all facts and circumstances relating to the employee's receipt of the benefit must be taken into account. For example, merchandise that is normally sold at retail with a warranty will not have a fair market value equal to the retail price when purchased by the employee at a discount and without a warranty. As a practical matter, it might be appropriate to provide that a warranty is assumed to account for a specified percentage of the retail price of an item. Similarly, a presumption could be established that imposing a standby condition on transportation would reduce the retail price of the transportation by a specified percentage. We believe the problems of valuation could be substantially reduced by such rules.

Commentators have suggested that the employer's allocated cost could be used to value fringe benefits. We are not convinced that the determination of an employer's allocated cost is substantially less difficult than the determination of fair market value in many cases. However, further consideration should be given to whether valuing fringe benefits at allocated cost plus an assumed fair rate of return on such cost would be more practical than valuing fringe benefits at fair market value.

Valuation problems could be reduced by taxing fringe benefits at the employer level. A tax at the employer level would avoid the need to allocate the value of fringe benefits to individual employee. For example, an employer that provides a free cafeteria for employees may have difficulty determining the value of the meals eaten by each employee. However, it would not be difficult to determine the aggregate value of all meals served in the cafeteria. Similarly, an employer may know the total amount of discounts allowed employees, but may find it difficult to allocate such discounts to individual employees.

Taxation at the employer level would also address the problem of imposing a substantial tax liability on employees who cannot convert their in-kind compensation into cash. Taxation at the employer level could be accomplished either by disallowing business deductions related to the fringe benefits or by imposing an excise tax on the employer on the value of all nonstatutory fringe benefits provided to employees. Either of these proposals could be combined with the allocated cost plus fair return method of valuation. In the case of disallowance of deductions, the employer's deduction for wages could then be reduced by an amount equal to the aggregate allocated cost of the fringe benefits provided to employees plus a fair rate of return on that cost.

Addressing the fringe benefit problem at the employer level would be fair. Such a solution simply says that if the employer wishes to provide compensation designed to avoid tax, he cannot have it both ways. He cannot design compensation that permits employees to pay no tax while still retaining the full tax benefit of deductions for himself. The system cannot afford growth of this inconsistent treatment by employers.

These proposals are not without their own problems. A significant problem of substituting disallowance of the employer's deduction for inclusion in the employee's income is that nontaxable entities would not be affected by such a provision. In addition, denial of the business expense deduction has the disadvantage of resulting in inequities between taxable employers depending on their marginal rate of tax, and of having the tax that is imposed with respect to the fringe benefit bear little, if any, relationship to the tax that would have been imposed on the employee.

Some of the disadvantages of denying deductions for business expenses might be avoided by imposing an excise tax on the value of fringe benefits provided by employers. Such an excise tax could be set at an average marginal rate where benefits in question are provided to employees on a nondiscriminatory basis, but at a higher rate where the benefits are provided only to highly compensated or key employees. Such an excise tax would affect all employers equally, without regard to their tax status or the amount of their taxable income.

In summary, we believe that the moratorium on fringe benefit regulations is having serious adverse effects on revenues and the tax system generally. However, we believe that political considerations make a regulatory solution to the problem impossible. Therefore, we believe that a comprehensive legislative approach to nonstatutory fringe benefits should be considered in place of a further extension of the moratorium. We would be happy to work with you to develop an acceptable legislative proposal.

*Statutory fringe benefits*

The area of statutory fringe benefits presents for the Treasury Department many of the same tax policy concerns which we have outlined above in our discussion of nonstatutory fringes. Statutory provisions currently exclude from an employee's income employer payments for up to $50,000 of group term life insurance, up to $5,000 of death benefits, health plans, medical expenses, rental of parsonages, certain benefits for members of the Armed Services, meals and lodging furnished for the convencience of the employer, group legal services plans, van pools, educational assistance programs, and dependent care assistance programs.

As these different exclusions proliferate in type, the programs under which they are offered are growing in both number and popularity. While we recognize that Congress in establishing the various statutory fringes has believed that a non-tax social policy justified each new exclusion, we doubt that Congress envisaged a system under which a significant portion of each employee's compensation is provided in nontaxable fringe benefits. The groundwork for just such a system is being rapidly established, however, through use of the cafeteria plan rules. We appreciate the efforts of this Committee to focus on the cafeteria plan rules as part of its examination of the entire fringe benefit problem.

A cafeteria plan is an arrangement by which an employer can enable its employees to choose among cash or a variety of statutory and nonstatutory fringe benefits. These "flexible benefit" plans were made possible by Code section 125, enacted by the Revenue Act of 1978. This section permits an employee to select a nontaxable benefit under a plan offering a variety of benefits without being subject to taxation on any nontaxable benefits selected. In the absence of section 125, under the doctrine of constructive receipt, the existence of an option to receive cash (or another taxable benefit) would result in taxation to the employee.

In order to qualify for the special tax treatment provided by section 125, a cafeteria plan must not discriminate as to employees' eligibility to participate and must not discriminate in favor of highly-compensated participants as to nontaxable fringe benefits (or employer contributions to such benefits). These nondiscrimination rules were designed to prevent use of cafeteria plans as a means by which highly compensated individuals can avoid or defer tax on a disproportionately high share of their compensation as compared to less highly compensated individuals.

Prior to the establishment of cafeteria plans, there was a practical limitation on the extent to which employers could provide compensation to employees in the form of non-taxable fringe benefits. Economically, any individual employee would prefer to receive more compensation in the form of non-taxable fringe benefits only if the employee needed or would use the additional fringe benefit as much as the cash payment that otherwise would be paid, less the tax that would be imposed on that cash compensation. The need for additional fringe benefits would differ from employee to employee. As a consequence, the provision of additional fringe benefits would be sought by some employees and opposed by others. In the past, employees as a group have reached a mutually satisfactory accommodation where the level of fringe benefits offered by each employer is acceptable to the employee group as a whole.

The level of benefits at which any group of employees develops conflicting interests will depend on the type of benefit being considered and the particular circumstances of the employees. For example, all employees may desire medical insurance protection up to a certain level. However, employees without dependents may want to limit the level of employer-provided health insurance to coverage for a single employee. Collectively, these employees will resist reducing their general level of cash compensation in order to provide more extensive insurance protection that would benefit only employees with dependents.

The establishment of cafeteria plans eliminates "employee jealousy" as a constraint upon the use of fringe benefits as a principal means of compensation. Under a properly designed cafeteria plan, an employee will never bear any portion of the economic cost of the fringe benefits enjoyed by other employees. Again looking to the example of medical insurance, an employee will not care if another employee receives tax-free comprehensive health insurance coverage for an entire family so long as he or she can receive either cash or an equivalent amount of compensation in the form of a desired tax-free fringe benefit.

The types of tax-free fringe benefits which are typically made available under cafeteria plans include disability benefits, accident and health insurance, group term life insurance, dependent care assistance, qualified group legal services, and a cash or deferred "section 401(k)" profit-sharing plan. The most common nonstatutory fringe benefits included in cafeteria plans are free parking and extra vacation days. However, as these plans become more widespread, the list of other available nonstatutory benefits could be expanded considerably. The ability to choose among these different fringe benefits which is facilitated by cafeteria plans, combined with the cash option feature, is virtually certain to expand significantly the level at which statutory fringe benefits are provided in lieu of taxable compensation.

The Treasury Department is concerned that there is a considerable potential for abuse of the cafeteria plan concept as as result of the availability of cash or taxable fringe benefits as a permissible plan distribution. Despite considerable efforts during the process of drafting the cafeteria plan regulations, we have found it particularly difficult to prevent this taxable benefit option from creating problems with respect to both salary reduction and discriminatory utilization of plan benefits.

It is unclear under Code section 125 or its legislative history whether Congress intended to permit widespread funding of cafeteria plans through the reduction of each participating employee's salary. The Treasury Department examined at length the difficulties of differentiating between a cash option and a salary reduction option during the process of drafting the proposed regulations under section 401(k). In the case of those qualified cash-or-deferred retirement arrangements, we proposed to permit the plans to be funded by salary reduction. By contrast, in the case of cafeteria plans, the availability of plan funding through salary reduction would permit employees to substitute for taxable wages unlimited amounts of fringe benefits which are tax-free by statute or are perceived to be tax-free under the moratorium on dealing with nonstatutory fringe benefits. Depending upon the timing of the salary reduction election, each participant in a cafeteria plan could select the maximum possible nontaxable benefit in light of his expenses for any taxable year, thereby simultaneously maximizing the government's revenue loss connected with these flexible benefit programs.

An example will illustrate the problems which would be created if cafeteria plans could be funded by salary reduction. Consider a cafeteria plan which offers company employees a choice between self-insured medical reimbursement benefits, dependent care assistance, life insurance benefits, "free" parking, or cash. The plan provides for a thirty percent reduction in the salaries of all participating employees. Under the terms of the plan, an employee can elect on a month-to-month basis the distribution of amounts paid out of the plan. Assume that employee A, who earns $50,000 per year, requests allocation of $15,000 between medical reimbursement and dependent care assistance, while Employee B, who also earns $50,000 per year, withdraws all his "contribution" in cash. Employee C and D, who earn $10,000 per year, each request $1,000 in medical reimbursement, a $500 contribution toward life insurance, and $1,500 in cash. Only the cash withdrawals are subject to tax. Thus in this example Employees A, C, and D save income and social security taxes on a total of $18,000, while the employer saves social security and unemployment taxes on the same amount. This program appears to be discriminatory in that tax-free benefits totalling $15,000 have been withdrawn by one of the highest-paid employees, while each of the lower-paid employees received only $1,500 in tax-free benefits. However, under the rules of section 125, this plan is not discriminatory. The plan benefits have been made available to all employees, and the nontaxable benefits withdrawn from the plan by the two highly-paid participants do not, as an average percentage of salary, exceed the nontaxable benefits withdrawn by the less highly compensated. It is extremely unlikely, however, that this plan could have been established were it not for the availability of the cash option. Employees B, C and D would have opposed creation of a generous plan of tax-free benefits which they would not expect to utilize fully in lieu of a portion of their cash compensation.

The addition of nonstatutory fringe benefits to cafeteria plans has increased the already substantial confusion about the taxability of such benefits. Many employees assume that any benefit other than cash received through a cafeteria plan is nontaxable. As described above, there is a need for legislative clarification of the tax treatment of nonstatutory fringe benefits. Until such clarification is made, we believe it is undesirable to aggravate the problems in the nonstatutory fringe benefit area by allowing such benefits to be included in cafeteria plans.

Absent legislative action, cafeteria plans will be used to an increasing extent to expand both the level and type of fringe benefits that will be provided to employees. To avoid both the revenue loss and potential discrimination caused by the taxable benefit option, the Treasury Department recommends that Congress limit both the types and amount of benefits available under cafeteria plans. We believe that the types of fringe benefits which can be offered under such plans should be restricted to cash, in a limited dollar amount, and to those statutory fringe benefits which are currently available under such plans. To the extent that salary reduction is perceived to be the practical equivalent of a cash option, the maximum amount of salary reduction by an employee participant in a cafeteria plan would be subject to the same annual dollar limitation applicable to cash payouts from the plan.

This concludes my prepared remarks. I would be happy to answer your questions.

Chairman STARK. I would also point out that our tax system is in danger when sound tax policy takes a back seat to extremely short-sighted political concerns.

Because of the large number of witnesses, we will hold to a strict 5-minute rule. I would ask unanimous consent that all prepared testimony be made a part of the record and that the press release announcing today's hearing also be made part of the record.

[Background material on the hearing follows:]

## THE PERMANENT TAX TREATMENT OF FRINGE BENEFITS ACT OF 1983

### BACKGROUND AND DESCRIPTION

### *I. Background*

The Internal Revenue Code defines gross income as including "all income from whatever source derived" and specifies that it includes "compensation for services" (Code section 61). The U.S. Supreme Court has held that Code section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."

In actual practice, however, the economic benefit test has not been rigidly followed. Thus, where compensation is paid in some form other than cash, its tax treatment has been resolved by statutory provisions, regulations, and administrative rulings and practices which take into account several different factors.

The statutory provisions governing the tax treatment of certain fringe benefits generally exclude from the employee's gross income the value of a defined benefit (usually subject to certain dollar or other limitations and to nondiscrimination requirements). These so-called "statutory" fringe benefits include, among others: (1) qualified pension, profit-sharing, and stock bonus plans; (2) up to $50,000 of group term life insurance; (3) accident or health benefits, including amounts paid by an employer to a health plan for the benefit of an employee; (4) up to $5,000 of death benefits; (5) parsonage allowances; (6) certain benefits provided to members of the armed forces; (7) meals and lodging for the convenience of the employer; (8) legal services; (9) commuting through use of a van pool; (10) employee educational assistance; and (11) dependent care assistance.

Exclusions for other so-called "nonstatutory" fringe benefits have been based on judicial authority or administrative practice. For example, some fringe benefits have been excluded from income because accounting for some occasional benefits of small value may be unreasonably burdensome or administratively impractical. Other items have been excluded due to a combination of valuation difficulties and widely held perceptions that particular items should not be taxed as income. However, there currently are no comprehensive statutory or administrative guidelines for distinguishing between taxable and nontaxable fringe benefits, although attempts to develop such guidelines have been made.

In 1975, in light of concerns over the increasing use of fringe benefits to compensate employees, the Treasury Department issued a discussion draft of proposed regulations which contained rules for determining whether various fringe benefits constitute taxable compensation. These rules would have resulted in the taxation of certain employee fringe benefits which had not been taxed as a matter of prior administrative practice. Considerable controversy arose in response to this proposal, and late in 1976, the Treasury withdrew this discussion draft. Thus, the question of whether a particular fringe benefit is taxable compensation to employees generally continues to depend on the facts and circumstances of each case and the policy of the IRS district in which the taxpayer is located.

In light of this controversy and the uncertainty facing taxpayers in this area, Congress acted in 1978 (Public Law 95-427) to prohibit the Treasury Department prior to 1980 from issuing final regulations under Code section 61 relating to the tax treatment of fringe benefits. This moratorium was subsequently extended by Public Law 96-167 through May 31, 1981, and by Public Law 97-34 through December 31, 1983.

During the past few years, proposals have been made recommending guidelines for the tax treatment of employee fringe benefits by the American Bar Association's Section of Taxation, the Federal Taxation Division of the American Institute of Certified Public Accountants, the Task Force on Employee Fringe Benefits of the Committee on Ways and Means in the 95th Congress chaired by the Honorable J. J. Pickle, the Tax Section of the New York State Bar, and the Treasury Department under President Carter in a discussion draft of proposed regulations submitted to the Committee on Ways and Means at the request of Chairman Rostenkowski. The present Administration also presented a regulatory proposal in testimony before this Subcommittee in May of 1981.

### *II. Description of the bill*

H.R. 3525 provides permanent rules for the tax treatment of those fringe benefits not specifically excluded from income by present law provisions of the Internal Revenue Code. Generally, gross income would not include any fringe benefit which qualifies as (1) a no-additional-cost service; (2) a qualified employee discount; (3) a working condition fringe; or (4) a de minimis fringe. These benefits also would be excluded from wages and benefits subject to social security or other employment taxes.

*A. No-additional-cost services.*—The bill defines an excludable no-additional-cost service as any service provided by an employer to an employee for use by such employee, the employee's spouse, or dependent child, if the service is provided to customers in the ordinary course of the employer's trade or business in which the employee works and if the employer incurs no substantial additional cost (including foregone revenue) in providing the service, determined without regard to any amounts paid by the employee in providing the service.

*B. Qualified employee discount.*—The bill defines an excludable qualified employee discount as the discount provided to an employee, the employee's spouse, or dependent child on property or services offered to customers in the ordinary course of the employer's trade or business in which the employee works, to the extent such discount does not exceed 20 percent of the retail price at which the discounted item is offered for sale by the employer to customers. If the employer's average profit percentage is less than 20 percent, the amount of discount excludable from income could not exceed this average percentage.

*C. Working condition fringe.*—The bill defines an excludable working condition fringe as any property or services which are provided primarily for the purpose of facilitating the employee's performance of service for the employer, but only if substantially all of the use of the property or services reasonably can be expected to occur in connection with the employee's performance of services. Under a special rule, the use of demonstrator autos by a car salesperson in the sales area would meet the latter use requirement if there are substantial restrictions on personal use. In addition, free or reduced cost parking would be treated as an excludable working condition fringe only if such parking is available on substantially the same terms to each member of a group of employees defined under a reasonable classification which does not discriminate in favor of officers, owners, or highly compensated employees.

*D. De minimis fringe.*—The bill defines an excludable de minimis fringe as any property or services whose value is so small as to make accounting for it unreasonable or administratively impractical. In determining whether the value of such property or services is small, all small-value property or services provided to an employee in a calendar year would be aggregated.

*E. Other issues.*— In order to qualify for the exclusion under the bill, both the no-additional-cost service fringe and the qualified employee discount fringe would have to be available on substantially the same terms to each member of a group of employees defined under a reasonable classification which does not discriminate in favor of officers, owners, or highly compensated employees. Special rules are provided for retired or disabled employees and leased sections of department stores.

Also excluded would be the value of on-premise gym and recreational facilities provided and operated by an employer for his employees where substantially all the use of the facility is by the employees (or their spouses or children). The employer's deductions for expenses (including depreciation) incurred in operating the facilities could not exceed the amount of gross income derived from the property, reduced by those deductions which are allowable regardless of their trade or business connection, unless the employer elects to include the value of the facility in the employee's income.

The bill would amend Code section 117 governing the tax treatment of scholarships to include certain tuition reduction programs. The rule would exclude from gross income the amount of any reduction in tuition provided by a qualifying educational organization to its employees for the education (below the graduate level) of the employee, the employee's spouse, or dependent child at the employing school, college, or university. This exclusion would not apply where reductions of the same kind are not available on substantially the same terms to each member of a group of employees defined under a reasonable classification which does not discriminate in favor of officers, owners, or highly compensated employees.

F. *Effective date.*—The provisions of the bill generally would take effect on January 1, 1984, except that the tuition reduction exclusion would apply with respect to education furnished after June 30, 1984.

G. *Coordination with present law.*—The bill provides rules for coordination with other provisions of present law. The exclusion provided by H.R. 3525 (other than a de minimis fringe) would not apply to any fringe benefit whose tax treatment is already expressly provided for by present law. The FICA, FUTA and Railroad Retirement tax bases and benefit eligibility would be conformed with the income tax base as revised by this bill.

In addition, an amendment would be made to Code section 125 relating to cafeteria plans to preclude benefits other than cash and statutory fringe benefits (other than educational assistance, van pooling, and the benefits covered in this bill) from utilization in cafeteria plans.

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98TH CONGRESS
1ST SESSION

# H. R. 3525

To provide permanent rules for the tax treatment of fringe benefits.

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IN THE HOUSE OF REPRESENTATIVES

JULY 12, 1983

Mr. STARK (for himself and Mr. CONABLE) introduced the following bill; which was referred to the Committee on Ways and Means

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# A BILL

To provide permanent rules for the tax treatment of fringe benefits.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

## SECTION 1. SHORT TITLE.

This Act may be cited as the "Permanent Tax Treatment of Fringe Benefits Act of 1983".

## SEC. 2. EXCLUSION OF CERTAIN FRINGE BENEFITS FROM GROSS INCOME.

(a) EXCLUSION OF CERTAIN FRINGE BENEFITS.—

(1) IN GENERAL.—Part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to items specifically excluded from gross income) is

amended by redesignating section 132 as section 133 and by inserting after section 131 the following new section:

"**SEC. 132. CERTAIN FRINGE BENEFITS.**

"(a) EXCLUSION FROM GROSS INCOME.—Gross income shall not include any fringe benefit which qualifies as a—

"(1) no-additional-cost service,

"(2) qualified employee discount,

"(3) working condition fringe, or

"(4) de minimis fringe.

"(b) NO-ADDITIONAL-COST SERVICE DEFINED.—For purposes of this section, the term 'no-additional-cost service' means any service provided by an employer to an employee for use by such employee if—

"(1) such service is provided to customers in the ordinary course of the trade or business of the employer in which the employee is performing services, and

"(2) the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service).

"(c) QUALIFIED EMPLOYEE DISCOUNT DEFINED.—For purposes of this section—

"(1) QUALIFIED EMPLOYEE DISCOUNT.—

"(A) IN GENERAL.—The term 'qualified employee discount' means any employee discount with respect to qualified property or services to the extent that such discount does not exceed 20 percent of the price at which the property or services are being offered by the employer to customers who are not employees.

"(B) SPECIAL RULE WHERE EMPLOYER'S PROFIT PERCENTAGE IS LESS THAN 20 PERCENT.—

"(i) IN GENERAL.—If the employer's profit percentage is less than 20 percent, subparagraph (A) shall be applied by substituting such profit percentage for '20 percent'.

"(ii) PROFIT PERCENTAGE.—For purposes of clause (i), the term 'profit percentage' means the percent which—

"(I) the excess of the aggregate sales price of property or services sold by the employer over their aggregate cost to the employer, is of

"(II) the aggregate sales price of such property or services.

"(iii) DETERMINATION OF PROFIT PERCENTAGE.—Profit percentage shall be determined on the basis of—

"(I) all property or services offered to customers in the course of the trade or business of the employer in which the employee is performing services (or a reasonable classification of property or services selected by the employer), and

"(II) the employer's experience during a representative period.

"(2) EMPLOYEE DISCOUNT DEFINED.—The term 'employee discount' means the amount by which—

"(A) the price at which the property or services are provided to the employee by the employer, is less than

"(B) the price at which such property or services are being offered by the employer to customers who are not employees.

"(3) QUALIFIED PROPERTY OR SERVICES.—The term 'qualified property or services' means any property or services which are offered for sale to customers in the ordinary course of the trade or business of the employer in which the employee is performing services.

"(d) WORKING CONDITION FRINGE DEFINED.—For purposes of this section, the term 'working condition fringe' means any property or services if—

"(1) such property or services are provided primarily for the purpose of facilitating the employee's performance of service for the employer, and

"(2) substantially all of the use of the property or services can reasonably be expected to occur in connection with the employee's performance of services.

"(e) DE MINIMIS FRINGE DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'de minimis fringe' means any property or service the value of which is so small as to make accounting for it unreasonable or administratively impracticable.

"(2) AGGREGATION RULE.—For purposes of applying paragraph (1), all small-value property or services provided to an employee during a calendar year shall be aggregated.

"(f) CERTAIN INDIVIDUALS TREATED AS EMPLOYEES FOR PURPOSES OF SUBSECTIONS (a) (1) AND (2).—

"(1) SPOUSE AND DEPENDENT CHILDREN.—

"(A) IN GENERAL.—For purposes of paragraphs (1) and (2) of subsection (a), any use by the spouse or a dependent child of the employee shall be treated as use by the employee.

"(B) DEPENDENT CHILD.—For purposes of subparagraph (A), the term 'dependent child' means any child (as defined in section 151(e)(3)) of the employee who is a dependent of the employee. For purposes of the preceding sentence, any child to whom section 152(e) applies shall be treated as the dependent of both parents.

"(2) RETIRED AND DISABLED EMPLOYEES.—For purposes of paragraphs (1) and (2) of subsection (a), the term 'employee' includes, with respect to a trade or business of an employer, any individual who was formerly employed by such employer in such trade or business and who separated from service with such employer in such trade or business by reason of retirement or disability.

"(g) SPECIAL RULES.—

"(1) EXCLUSIONS UNDER SUBSECTION (a) (1) AND (2) APPLY ONLY IF NO DISCRIMINATION.—Paragraphs (1) and (2) of subsection (a) shall apply with respect to any fringe benefit described therein only if such fringe benefit is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees.

"(2) SPECIAL RULE FOR LEASED SECTIONS OF DEPARTMENT STORES.—

"(A) IN GENERAL.—For purposes of paragraph (2) of subsection (a), in the case of a leased section of a department store—

"(i) such section shall be treated as part of the trade or business of the person operating the department store, and

"(ii) employees in the leased section shall be treated as employees of the person operating the department store.

"(B) LEASED SECTION OF DEPARTMENT STORE.—For purposes of subparagraph (A), a leased section of a department store is any part of a department store where over-the-counter sales of property are made under a lease or similar arrangement where it appears to the general public that individuals making such sales are employed by the person operating the department store.

"(3) AUTO SALESMEN.—

"(A) IN GENERAL.—For purposes of subsection (d)(2), qualified automobile demonstration use shall be treated as use in connection with the employee's performance of service.

"(B) QUALIFIED AUTOMOBILE DEMONSTRATION USE.—For purposes of subparagraph (A), the term 'qualified automobile demonstration use' means any use of an automobile by an automobile salesman in the sales area in which the automobile dealer's sales office is located if there are substantial restrictions on the personal use of such automobile by such salesman.

"(4) PARKING.—For purposes of this section, the term 'working condition fringe' includes providing parking to an employee if (and only if) such parking is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees.

"(5) ON-PREMISES GYMS AND OTHER RECREATIONAL FACILITIES.—

"(A) IN GENERAL.—Gross income shall not include the value of any on-premises recreational facility provided by an employer to his employees.

"(B) EXCEPTION WHERE EMPLOYER ELECTS INCLUSION IN LIEU OF DENIAL OF DE-

DUCTION.—Subparagraph (A) shall not apply with respect to any on-premises recreational facility provided by an employer to his employees during any taxable year of the employer if an election by the employer under section 280F(b) applies to such facility for such taxable year.

"(C) ON-PREMISES RECREATIONAL FACILITY.—For purposes of this paragraph, the term 'on-premises recreational facility' means any gym or other recreational facility—

"(i) which is located on the premises of the employer,

"(ii) which is operated by the employer, and

"(iii) substantially all the use of which is by employees of the employer, their spouses, and their dependent children (within the meaning of subsection (f)(1)(B)).

"(h) SECTION NOT TO APPLY TO FRINGE BENEFITS EXPRESSLY PROVIDED FOR ELSEWHERE.—This section (other than subsection (e)) shall not apply to any fringe benefit of a type the tax treatment of which is expressly provided for in any other section of this chapter.

"(i) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section."

(2) CLERICAL AMENDMENT.—The table of sections for such part III is amended by striking out the item relating to section 132 and insertingf in lieu thereof the following:

"Sec. 132. Certain fringe benefits.
"Sec. 133. Cross references to other Acts."

(b) LIMITATION ON DEDUCTION FOR ON-PREMISES RECREATIONAL FACILITIES.—

(1) Part IX of subchapter B of chapter 1 of such Code (relating to items not deductible) is amended by adding at the end thereof the following new section:

**"SEC. 280F. LIMITATION ON DEDUCTION FOR OPERATING ON-PREMISES EMPLOYEE RECREATIONAL FACILITIES.**

"(a) GENERAL RULE.—Except as otherwise provided in this section, the deductions allowed under this chapter to an employer with respect to any on-premises recreational facility shall not exceed the excess of—

"(1) the gross income derived from such facility for the taxable year, over

"(2) the deductions allocable to such facility which are allowable under this chapter for the taxable year without regard to their connection with the trade or business.

"(b) ELECTION OF EMPLOYEE INCOME INCLUSION IN LIEU OF DISALLOWANCE OF DEDUCTION.—

"(1) IN GENERAL.—Subsection (a) shall not apply to any taxable year of the employer if an election made by such employer under this subsection applies to such taxable year.

"(2) SCOPE.—Except as otherwise provided in regulations, any election under this subsection shall apply to all on-premises recreational facilities of the employer.

"(3) MANNER AND TIME OF ELECTION.—An election under paragraph (1) for any taxable year shall be made at such time and in such manner as the Secretary shall by regulations prescribe. An election, once made for any taxable year, may be revoked only with the consent of the Secretary.

"(c) ON-PREMISES RECREATIONAL FACILITY.—For purposes of this section, the term 'on-premises recreational facility' has the meaning given to such term by section 132(g)(5)(C).

"(d) EXCEPTION FOR INTEREST, TAXES, ETC.—Subsection (a) shall not apply to any deduction allowable under this chapter to the employer without regard to its connection with his trade or business."

(2) CLERICAL AMENDMENT.—The table of subchapters for part IX of subchapter B of chapter 1 of such Code is amended by adding at the end thereof the following new item:

"Sec. 280F. Limitation on deduction for operating on-premises employee recreational facilities."

(c) DEFINITION OF CAFETERIA PLAN.—

(1) IN GENERAL.—Paragraph (1) of section 125(d) of such Code (defining cafeteria plan) is amended to read as follows:

"(1) IN GENERAL.—The term 'cafeteria plan' means a written plan under which—

"(A) all participants are employees, and

"(B) the participants may choose among 2 or more benefits consisting of cash and statutory nontaxable benefits."

(2) DEFINITION OF STATUTORY NONTAXABLE BENEFIT.—Subsection (f) of section 125 of such Code is amended to read as follows:

"(f) STATUTORY NONTAXABLE BENEFITS DEFINED.—For purposes of this section, the term 'statutory nontaxable benefit' means any benefit which, with the application of subsection (a), is not includible in the gross income of the employee by reason of an express provision of this chapter (other than sections 117, 124, 127, or 132)."

(3) TECHNICAL AMENDMENT.—Subsection (c) of section 125 of such Code is amended by striking out "nontaxable benefits" each place it appears and inserting in lieu thereof "statutory nontaxable benefits".

(d) CONFORMING AMENDMENTS TO EMPLOYMENT TAXES.—

(1) SOCIAL SECURITY TAXES.—

(A) Subsection (a) of section 3121 of such Code (defining wages) is amended by striking out "or" at the end of paragraph (18), by striking out the period at the end of paragraph (19) and inserting in lieu thereof "; or", and by inserting after paragraph (19) the following new paragraph:

"(20) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132."

(B) Section 209 of the Social Security Act is amended by striking out "or" at the end of subsection (q), by striking out the period at the end of subsection (r) and inserting in lieu thereof "; or", and by inserting after subsection (r) the following new subsection:

"(s) Any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132 of the Internal Revenue Code of 1954."

(2) RAILROAD RETIREMENT TAX.—Subsection (e) of section 3231 of such Code (defining compensation) is amended by adding at the end thereof the following new paragraph:

"(5) The term 'compensation' shall not include any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132."

(3) UNEMPLOYMENT TAX.—Subsection (b) of section 3306 of such Code (defining wages) is amended by striking out "or" at the end of paragraph (13), by striking out the period at the end of paragraph (14) and inserting in lieu thereof "; or", and by inserting after paragraph (14) the following new paragraph:

"(15) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132."

(4) WITHHOLDING.—Subsection (a) of section 3401 of such Code (defining wages) is amended by striking out "or" at the end of paragraph (18), by striking out the period at the end of paragraph (19) and inserting in lieu thereof "; or", and by adding at the end thereof the following new paragraph:

"(20) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132."

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1984.

### SEC. 3. EXCLUSION FROM GROSS INCOME OF CERTAIN REDUCTIONS IN TUITION.

(a) IN GENERAL.—Section 117 of the Internal Revenue Code of 1954 (relating to scholarships and fellowship grants) is amended by adding at the end thereof the following new subsection:

"(d) QUALIFIED TUITION REDUCTIONS.—

"(1) IN GENERAL.—Gross income shall not include any qualified tuition reduction.

"(2) QUALIFIED TUITION REDUCTION.—For purposes of this subsection, the term 'qualified tuition reduction' means the amount of any reduction in tuition provided by an organization described in section

170(b)(1)(A)(ii) to an employee of such organization for the education (below the graduate level) at such organization of—

"(A) such employee,

"(B) the spouse of such employee, or

"(C) any child (as defined in section 151(e)(3)) of such employee who is a dependent of such employee.

For purposes of subparagraph (C), any child to whom section 152(e) applies shall be treated as the dependent of both parents.

"(3) REDUCTION MUST NOT DISCRIMINATE IN FAVOR OF HIGHLY COMPENSATED, ETC.—Paragraph (1) shall apply with respect to any qualified tuition reduction only if such reduction is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to qualified tuition reductions (as defined in section 117(d)(2) of the Internal Revenue Code of 1954) for education furnished after June 30, 1984, in taxable years ending after such date.

[JOINT COMMITTEE PRINT]

# DESCRIPTION OF H.R. 3525 (PERMANENT TAX TREATMENT OF FRINGE BENEFITS ACT OF 1983)

SCHEDULED FOR A HEARING
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
COMMITTEE ON WAYS AND MEANS
ON AUGUST 1, 1983

PREPARED BY THE STAFF
OF THE
JOINT COMMITTEE ON TAXATION

JULY 28, 1983

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# INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on August 1, 1983, on H.R. 3525 (Permanent Tax Treatment of Fringe Benefits Act of 1983). The bill was introduced on July 12, 1983, by Messrs. Stark and Conable.

The first part of the pamphlet is a summary. The second part is a general overview of the Federal tax treatment of statutory and nonstatutory fringe benefits. This is followed by a brief statement of some of the principal tax issues relating to fringe benefits. The final part of the pamphlet is a description of H.R. 3525.

# I. SUMMARY

### *Statutory exclusions for certain fringe benefits*

As a general rule, if an employer-provided fringe benefit program qualifies under certain statutory provisions of the Internal Revenue Code, the benefits provided under the program are excludable (generally, subject to dollar or other limitations) from the employee's gross income for income tax purposes and from wages for payroll tax purposes. The employer's costs of providing benefits which are excluded from the employee's income nonetheless generally are deductible by the employer (as are employee benefit costs not so excluded), provided that such costs constitute ordinary and necessary business expenses deductible under Code section 162.

The Internal Revenue Code provides specific exclusions, among others, with respect to employer provision of (1) health or accident benefits; (2) up to $50,000 of group-term life insurance; (3) up to $5,000 of death benefits; (4) meals and lodging for the convenience of the employer; (5) legal services; (6) commuting through use of a van pool; (7) employee educational assistance; (8) dependent care assistance; (9) certain benefits provided to members of the Armed Services; and (10) and parsonage allowances.

### *Tax treatment of nonstatutory fringe benefits*

The Internal Revenue Code defines gross income as including "all income from whatever source derived" and specifies that it includes "compensation for services" (sec. 61). The U.S. Supreme Court has held that Code section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."

In actual practice, however, the economic benefit test has not been rigidly followed. Thus, where compensation is paid in some form other than cash, issues as to taxability of certain fringe benefits have been resolved by judicial decisions, regulations, rulings, or other administrative practices which take into account several different factors.

The Economic Recovery Tax Act of 1981 (P.L. 97-34) extended through December 31, 1983 the moratorium, first enacted in 1978, on the issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits.

### *H.R. 3525*

Under the bill, certain fringe benefits provided by an employer would be excluded from the recipient employee's gross income for Federal income tax purposes and from the wage and benefit base for purposes of social security and other employment taxes.

The excluded fringe benefits would be those that qualify under one of the following four categories as defined in the bill: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, or (4) a de minimis fringe. The bill would include rules with respect to parking provided to employees, demonstration use of an employer-provided car by auto salespersons, and employee use of gyms and other recreational facilities on the premises of an employer. Also, the bill would provide an exclusion for certain tuition reductions provided by and at a school or college to its employees, or their spouses or children. In the case of a no-additional-cost service, a qualified employee discount, parking, or a tuition reduction, the exclusion would apply only if the benefit is made available to employees on a nondiscriminatory basis.

Any fringe benefit which does not qualify for exclusion under the bill (for example, free or discounted goods or services which are limited to corporate officers) or under another specific statutory fringe benefit provision is taxable to the recipient, under Code sections 61 and 83, at the excess of its fair market value over any amount paid by the employee for the benefit.

The provisions of the bill generally would take effect on January 1, 1984, except that the tuition reduction exclusion would apply with respect to education furnished after June 30, 1984.

# II. OVERVIEW OF TAX TREATMENT OF FRINGE BENEFITS

## A. Statutory Exclusions

### *In general*

As a general rule, if an employer-provided fringe benefit program qualifies under certain statutory provisions of the Internal Revenue Code, the benefits provided under the program are excludable (generally, subject to dollar or other limitations) from the employee's gross income for income tax purposes and from wages for payroll tax purposes. The employer's costs of providing benefits which are excluded from the employee's income nonetheless generally are deductible by the employer (as are employee benefit costs not so excluded), provided that such costs constitute ordinary and necessary business expenses deductible under Code section 162.

The Internal Revenue Code provides specific exclusions, among others, with respect to employer provision of (1) health or accident benefits; (2) up to $50,000 of group-term life insurance; (3) up to $5,000 of death benefits; (4) meals and lodging for the convenience of the employer; (5) legal services; (6) commuting through use of a van pool; (7) employee educational assistance; (8) dependent care assistance; (9) certain benefits provided to members of the Armed Services; and (10) parsonage allowances.

### *Nondiscrimination rules*

Many of the present-law exclusions for statutory fringe benefits include rules prohibiting discrimination in favor of owners, officers, shareholders, or highly compensated employees.

Under these rules, a benefit plan or program generally must meet a requirement of nondiscrimination as to eligibility to participate, by covering a classification of employees determined by the Internal Revenue Service not to result in prohibited discrimination. A self-insured medical reimbursement plan or a group-term life insurance plan may also satisfy the requirement by covering a stated percentage of employees.

The eligibility rules generally permit employees covered by a collective bargaining agreement to be excluded from consideration if the benefits provided by the plan or program were the subject of good faith bargaining between the employer and employee representatives. The eligibility rules for self-insured medical reimbursement plans and group-term life insurance plans also provide that employees need not be taken into account if they have not completed three years of service or are part-time or seasonal employees (or, in the case of self-insured medical reimbursement plans, if they have not attained age 25).

The present-law nondiscrimination rules applicable to certain types of fringe benefit plans and programs also prohibit discrimination as to contributions or benefits. With respect to self-insured medical reimbursement plans, or group-term life insurance plans, present law specifically requires that all benefits available to officers, 10-percent shareholders, or highly compensated individuals must also be available to all other plan participants.

Under present law, if a plan is determined to discriminate in favor of employees who are officers, shareholders, or highly compensated, the otherwise applicable income exclusion generally is denied for all benefits provided under the plan, including those benefits provided for rank-and-file employees. (The nondiscrimination rules generally do not provide express guidance as to when an employee is considered highly compensated, or the extent of stock ownership required before an employee is considered a shareholder.) However, under a discriminatory self-insured medical reimbursement plan or group term life insurance plan, only those employees with respect to whom discrimination is prohibited are required to include amounts in gross income; other employees retain the benefit of the income exclusion.

### *Cafeteria plans*

Under present law, an employer may maintain a cafeteria plan under which an employee may choose from a package of employer-provided fringe benefits, some of which may be taxable (e.g., cash or group-term life insurance in excess of $50,000) and some of which are nontaxable (e.g., health and accident insurance). The mere availability of cash or taxable benefits under a cafeteria plan will not cause an employee to forfeit an otherwise applicable income exclusion (sec. 125). Thus, benefits provided under a cafeteria plan generally are excluded to the extent that nontaxable benefits are elected.

No exclusion is permitted, however, for participants who are highly compensated individuals if the cafeteria plan discriminates in favor of such individuals as to eligibility or as to benefits or contributions. For this purpose, a highly compensated individual includes an officer, a five percent shareholder, a highly compensated individual, or a spouse or dependent of any of the preceding individuals. A special safe harbor rule is provided for testing whether health benefits under a cafeteria plan are discriminatory.

## B. Nonstatutory Fringe Benefits

### *Background*

The Internal Revenue Code defines gross income as including "all income from whatever source derived", and specifies that it includes "compensation for services" (sec. 61). Treasury regulations provide that gross income includes compensation for services paid other than in money (Reg. sec. 1.61-1(a)). Further, the U.S. Supreme Court has stated that Code section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." [1]

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[1] *Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945). *See also Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955) ("Congress applied no limitations as to the source of taxable re-

Continued

In actual practice, however, the economic benefit test has not been rigidly followed in all situations. Thus, where compensation is paid in a form other than cash, issues as to the taxability of certain fringe benefits have been resolved by judicial decisions, regulations, rulings, or other administrative practices which take into account several different factors. For example, some economic or financial benefits furnished as compensation have been treated as excluded from income on the basis of de minimis principles; that is, accounting for some occasional benefits of small value may be viewed as unreasonably burdensome or administratively impractical. Other items have been treated as excluded in light of a combination of valuation difficulties and widely held perceptions that the particular items should not be taxed as income.

### *1975 Treasury discussion draft*

In 1975, the Treasury Department issued a discussion draft of proposed regulations[2] which contained a number of rules for determining whether various nonstatutory fringe benefits constitute taxable compensation. The discussion draft was withdrawn by the Treasury Department on December 28, 1976.[3] Thus, the question of whether, and what, employee fringe benefits result in taxable income generally continued to depend on the facts and circumstances in each individual case.

The 1975 discussion draft proposed a "safe harbor" (i.e., nontaxable treatment) for fringe benefits meeting all of three tests: (1) the goods or services provided to the employee were owned or provided by the employer in connection with a regular trade or business; (2) the employer incurred no substantial incremental costs in furnishing the goods or services to the employee; and (3) the goods or services were made available to employees on a nondiscriminatory basis. Fringe benefits not qualifying under the safe harbor would have been evaluated in terms of a nine-part facts and circumstances test, with no single factor deemed to be controlling. In addition, the discussion draft provided a de minimis rule exempting from taxation fringe benefits of little value.

If an item was required to be taken into income under the 1975 discussion draft, the amount includible in gross income constituted the amount the employee would have had to pay for the goods or services on an arm's-length basis (i.e., fair market value).

### *Ways and Means Task Force discussion draft bill*

On January 22, 1979, the Task Force on Employee Fringe Benefits of the House Committee on Ways and Means issued a discussion draft report and bill on fringe benefits.[4] No further action was taken by the Ways and Means Committee on the Task Force Report. The Task Force discussion draft bill would have excluded from gross income certain fringe benefits that qualified under

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ceipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted.")

[2] 40 Fed. Reg. 4118 (Sept. 5, 1975).

[3] 41 Fed. Reg. 5634 (Dec. 28, 1976).

[4] House Committee on Ways and Means, Discussion Draft Bill and Report on Employee Fringe Benefits (Comm. Print No. 96-8, 1979).

either (1) a safe harbor test, (2) a convenience of the employer test, (3) a de minimis test, or (4) regulations issued by the Treasury. Any other fringe benefits received by an employee would be includible in gross income at fair market value (less any amount paid by the employee for the benefits).

Under the safe harbor test in the Task Force bill, a fringe benefit would be excluded from gross income if: (1) it is made available to employees generally or to a reasonable classification of employees, (2) the employer incurs no substantial incremental cost in providing the fringe benefit, and (3) the total value of all fringe benefits received during the taxable year by the employee is not substantial, either in absolute terms or relative to the amount of compensation of the employee.

The convenience of the employer test would exclude from gross income fringe benefits made available primarily for the purpose of facilitating the employee's performance of services for the employer.

Under the de minimis rule in the Task Force bill, a fringe benefit would be excluded from gross income if its value is so small as to make accounting for it unreasonable or administratively impractical.

### *1981 Treasury discussion draft*

On January 15, 1981, the Treasury Department forwarded to the House Committee on Ways and Means a revised "discussion draft" of proposed regulations on the tax treatment of fringe benefits.[5]

Under the 1981 discussion draft, the value of property, services, or facilities furnished by an employer in connection with the performance of services by an employee generally would be included in the employee's gross income. The value of any fringe benefit included in gross income would be the amount by which the fair market value of the item or its use exceeds any amount paid by the employee for the item or its use.

Certain exceptions to the general rule would have been provided. Fringe benefits consisting of items furnished by an employer with the specific intent either to enable or facilitate the performance of employment services by the recipient would be excluded from gross income. In addition, certain items would be excluded from gross income for reasons of administrative convenience, which would be determined on the basis of the facts and circumstances.

Finally, the 1981 discussion draft would exclude from gross income nondiscriminatory free or discount parking provided to employees, and occasional noncash gifts of up to $25 in value per gift.

### *Moratorium on issuance of regulations*

Public Law 95-427, enacted in 1978, prohibited the Treasury Department from issuing, prior to 1980, final regulations relating to the income tax treatment of fringe benefits. That statute further provided that no regulations relating to the treatment of fringe benefits were to be proposed that would be effective prior to 1980.

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[5] This discussion draft was not reviewed by the Secretary of the Treasury and was not published in the Federal Register. The discussion draft was reprinted in various publications, including Bureau of National Affairs, Daily Executive Report (Jan. 16, 1981), at p. J-14.

Public Law 96-167, enacted in 1979, extended the moratorium on issuance of final fringe benefit regulations through May 31, 1981. Public Law 97-34 (the Economic Recovery Tax Act of 1981) extended the moratorium through December 31, 1983.

## III. ISSUES RELATED TO TAX TREATMENT OF FRINGE BENEFITS

### *In general*

1. Present law imposes a higher tax liability on an individual who receives no employee fringe benefits (whether or not the individual purchases the item individually) than on another individual with the same amount of economic income partially received in the form of fringe benefits which are statutorily excluded from income or are treated as tax-free because of the moratorium. Some have suggested that such disparate treatment reduces horizontal equity and contributes to the perception that the tax system is unfair.

2. By excluding certain fringe benefits from taxation, present law may encourage greater consumption of the benefit then would occur in the absence of a tax system. Some believe that the artificial subsidy of the price of certain goods and services reduces economic efficiency and distorts the ability of consumers to obtain maximum satisfaction from available resources. Further, some believe that the exclusion of certain elements of income from the tax base requires higher marginal tax rates on income which remains taxable, in order to raise the same revenue. Some suggest that these higher rates interfere with incentives to work, save, and invest. In contrast, others argue that the tax system should encourage the greater consumption of certain items because this provides a significant benefit to society which individuals do not take into account when making their consumption decisions.

3. By excluding certain fringe benefits from taxation, present law avoids administrative difficulties which could be encountered in valuing some noncash forms of compensation.

4. Some believe that rules which prohibit discrimination in favor of owners and highly compensated employees in the provision of tax-free fringe benefits are sufficient to prevent abuse. Others argue that these rules do little to limit the amount of income excluded from tax, and, thus, the revenue loss and inequity resulting from this treatment.

### *Moratorium on fringe benefit regulations*

Some suggest that the moratorium on the issuance of fringe benefit regulations should be extended at least for another two-year period. In light of disagreements as to the proper tax treatment of certain nonstatutory fringe benefits, it is argued that there should be additional time to consider the issue of subjecting to taxation benefits which are widely available to many workers, which many taxpayers do not view as either equivalent to cash or taxable compensation, and for which there could be substantial valuation and recordkeeping problems for employers and employees alike.

Others believe that the moratorium should not be extended beyond 1983, and that the Congress either should enact guidelines for the exclusion or taxability of particular types of common nonstatutory employee fringe benefits (e.g., discounts on employer-produced goods or services, free transportation provided to employees in the transportation business, subsidized or free parking and cafeterias, etc.), or should permit the Treasury to continue its efforts to develop such rules by regulation. They suggest that extending the moratorium would encourage increased use of such benefits in lieu of cash compensation, with corresponding loss in revenue and inequality of treatment between employees of different industries, e.g., between employees of industries which can provide desirable benefits at little or no cost and employees of other industries which cannot. Also, they believe that questions as to the applicability of the moratorium to the taxation of particular fringe benefits have caused confusion and uncertainty for taxpayers and the Internal Revenue Service, as well as lack of uniform treatment among similarly situated taxpayers.

## IV. EXPLANATION OF H.R. 3525

### *In General*

Under the bill, certain fringe benefits provided by an employer would be excluded from the recipient employee's gross income for Federal income tax purposes and from the wage and benefit base for purposes of social security and other employment taxes.

The excluded fringe benefits would be those benefits that qualify under one of the following four categories as defined in the bill: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, or (4) a de minimis fringe. Special rules would apply with respect to parking provided to employees, demonstration use of an employer-provided car by auto salespersons, and employee use of gyms and other recreational facilities on the premises of an employer. Also, the bill would provide an exclusion for certain tuition reductions provided by and at a school or college to its employees, or their spouses or children. In the case of a no-additional-cost service, a qualified employee discount, parking, or a tuition reduction, the exclusion would apply only if the benefit is made available to employees on a nondiscriminatory basis.

Any fringe benefit which does not qualify for exclusion under the bill (for example, free or discounted goods or services which are limited to corporate officers) or under another specific statutory fringe benefit provision is taxable to the recipient, under Code sections 61 and 83, at the excess of its fair market value over any amount paid by the employee for the benefit.

The provisions of the bill generally would take effect on January 1, 1984, except that the tuition reduction exclusion would apply with respect to education furnished after June 30, 1984.

### *No-additional-cost Service*

Under this category, the entire value of any no-additional-cost service provided by an employer to an employee for the use of the employee (or of the employee's spouse or dependent children) would be excluded for income and employment tax purposes, but only if the service is available to employees on a nondiscriminatory basis (see discussion below of nondiscrimination rules).

To qualify under this exclusion, the service must be of the same type which is sold to the public in the ordinary course of the employer's trade or business in which the employee works, and the employer must incur no substantial additional cost in providing the service to the employee. For this purpose, the term cost would include any indirect cost and any revenue foregone because the service had been made available to the employee rather than to the general public. The determination of whether the employer had incurred any substantial additional cost in providing the benefit would be made without regard to any amounts paid by the employee for the service.

The exclusion would also be available where qualifying no-additional-cost service is provided by an employer to and for the use of an individual (or the individual's spouse or children) who formerly worked for the employer in the employer's trade or business in which the service is being provided and who separated from service with the employer in that trade or business because of retirement or disability.

As an illustration of this category of excludable benefits, assume that a corporation which operates an airline as its only trade or business adopts a policy of providing all of its employees (and their spouses and children) with free travel as stand-by passengers on the employer airline if the space taken on the flight had not been sold to the public by departure time, and that this benefit is available on terms that satisfy the bill's nondiscrimination requirements. In such a case, the entire fair market value of the free travel would be excluded under the no-additional-cost service rule in the bill. This conclusion follows because the service provided by the employer to its employees who work in the employer's airline trade or business is the same as that sold to the general public (airline flight), the service is provided at no substantial additional cost to the employer (the seat would have been unsold if the employee had not taken the trip), and the eligibility terms satisfy the nondiscrimination requirements because all employees are eligible for the benefit on the same terms.

On the other hand, this exclusion category would not apply, for example, where employees in the hotel trade or business of a corporation receive free stand-by travel on an airline operated by the same corporation, where employees of one airline receive free stand-by travel benefits on another airline through reciprocal arrangements, or where employees of a consumer goods manufacturer are allowed to travel for personal trips on a company plane or automobile even though the plane or automobile otherwise is making a trip on company business. In each of these cases, even if there were no substantial additional cost to the trade or business in providing the service, the benefit is not a service generally provided to the general public in the specific trade or business of the employer in which the employee-recipient is at the time providing services. Accordingly, the requirements of the no-additional-cost exclusion would not be satisfied.

### *Qualified Employee Discount*

#### *In general*

Under this category, qualified discounts allowed to an employee from the selling price of the employer's goods or services (for use by the employee or the employee's spouse or dependent children) would be excluded, up to 20 percent of the selling price, for income and employment tax purposes, but only if available to employees on a nondiscriminatory basis (see discussion below of nondiscrimination rules).

To qualify under this exclusion, the goods or services on which the discount is available must be those which are offered for sale by the employer to the general public in the ordinary course of the employer's trade or business in which the employee works. For example, goods held for sale in the retail department store trade or business of a firm would be eligible for the discount exclusion if purchased at a discount by an employee of the firm who works in that trade or business.

The exclusion would also be available where a qualified discount is provided by an employer to an individual (for use of the individual or of the individual's spouse or dependent children) if the individual had formerly worked for the employer in the employer's trade or business in which the goods or services are being provided and who separated from service with the employer in that trade or business because of retirement or disability.

### *Limitation on exclusion*

The excludable amount of the discount would be limited to the lesser of (1) 20 percent of the price at which the goods or services are offered to nonemployee customers by the employer or (2) the employer's profit percentage, as defined in the bill.

For this purpose, the employer's profit percentage would mean the amount by which the aggregate sales price for the year of property or services sold by the employer exceeds their aggregate cost to the employer, divided by the aggregate sales price. For example, if total sales of a product during the year were $1 million and the employer's cost of the product was $850,000, then the profit percentage would be 15 percent ($1 million minus $850,000 divided by $1 million). Thus, if (for example) any employee were allowed a 19-percent discount by the employer, the excludable discount would be limited to 15 percent, and the additional discount of four percent would not be excludable.

The bill would provide that an employer may compute the profit percentage on the basis of all property or services held for sale or provided to customers in the employer's trade or business in which the employee works. As an alternative, the employer could select any reasonable classification of such property or services. For example, a retail department store business could compute a profit percentage for the store business as a whole, or may select different profit percentages for different departments or types of goods (high markup items versus low markup items), provided the classification is made on a reasonable basis. Under either computation method, the determination of the profit percentage is to be made on the basis of the employer's experience during a representative period.

### *Leased sections of department stores*

In cases where a department store leases floor space to another employer (such as a cosmetics firm), and employees of the lessee engage in over-the-counter sales of property which appear to the public to be made by department store employees, then, for purposes of the exclusion in the bill for qualified employee discounts, the leased section would be considered as part of the department store and the employees of the leased section would be considered to be employees of the department store. Thus, even if individuals selling cosmetics on the department store floor are actually employees of the cosmetic company rather than of the store, they would be considered employees of the department store for purposes of the exclusion for qualified employee discounts. Therefore, if they receive from the store a qualified discount on their purchases of items in the store other than cosmetics, the amount of the discount (subject to the percentage limitation) would be excluded from income. Likewise, since the cosmetic section itself would be considered as part of the department store, any qualified discount allowed to department store employees by the cosmetics firm to purchase cosmetics would be excludable from income (subject to the percentage limitation).

## *Working Condition Fringe*

### *In general*

Under the bill, the fair market value of property or services provided primarily for the purpose of facilitating the particular employee's work for the employer would be excluded for income and employment tax purposes. This working condition exclusion would apply however, only if substantially all (for this purpose, at least 85 percent) of the use of the property or services reasonably can be expected to occur in connection with that employee's performance of services, i.e., for business purposes. For example, if an employee is provided with a company car primarily for business use and less than 15 percent of the employee's use of the car is for personal purposes, the entire value of the use of the automobile would be excludable. If the 15-percent personal use limitation is exceeded, this exclusion would not be available.

A benefit generally would be treated as a working condition fringe if it is provided by an employer primarily for the safety of its employees. For example, if for security reasons the U.S. Government provides a bodyguard or chauffered limousine to an employee stationed in a foreign country, the value of the bodyguard or of use of the limousine would be treated as a working condition fringe benefit that is not taxable to the employee. Other examples of benefits that generally would be excluded as working condition fringes include office furnishings and supplies, taxi fare provided to secretaries working late at night, and use of on-premises first-aid stations.

### *Parking*

The fair market value of free or reduced cost parking would be excluded as a working condition fringe only if such parking is available on a nondiscriminatory basis (see discussion below of nondiscrimination rules).

### *Demonstration use by auto salespersons*

Under the bill, the fair market value of the use of an employer-provided car by an automobile salesperson would be considered an excludable working condition fringe if (1) the car is provided primarily for the purpose of facilitating the employee's performance of services for the employer, (2) substantially all the use of the car by the salesperson occurs in the geographic sales area in which the auto dealer's sales office is located, and (3) there are substantial restrictions on the personal use of the car by the salesperson. For example, if an auto salesperson is required to drive the make of car which the auto dealer sells, is limited in the amount of miles he or she may drive the auto, may not store personal possessions in the auto, and is prohibited from using the car for vacation trips, such restrictions generally would be considered substantial for purposes of this rule.

### *De Minimis Fringe*

Under the bill, if the fair market value of property or services which otherwise would be a taxable fringe benefit is so small that accounting for it would be unreasonable or administratively unpracticable, then the value would be excluded for income and employment tax purposes.

In determining whether the de minimis exclusion applies, the values of all property or services provided to an employee during a calendar year would be aggregated, except for (1) property or services that are excluded from taxation under a specific statutory exclusion provision (such as qualified employee discounts) and (2) any other property or service provided to the employee which had more than a small fair market value. Examples of benefits which generally would be excludable as de minimis fringes would include the typing of personal letters by an employee's secretary, occasional company cocktail parties or picnics for employees, traditional holiday gifts of property with a low fair market value, and reduced-cost cafeterias available to all employees.

### *Nondiscrimination Rules*

To qualify under the bill for the no-additional-cost service exclusion, the qualified employee discount exclusion, the parking exclusion, or the qualified tuition reduction exclusion (described below), the benefit must be available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer that does not discriminate in favor of officers, owners, or highly compensated employees.

The determination of whether a particular classification is reasonable would depend on the facts and circumstances involved. A classification that, on its face, provides benefits only to officers, shareholders, or highly compensated employees is per se discriminatory, and no exclusion would be available for the value of such benefits. On the other hand, an employer could establish a classification that is based on certain appropriate factors, such as seniority or job description, provided that the effect of the classification is nondiscriminatory. Thus, for example, if an employer makes free or reduced-cost parking available to all its employees on the basis of seniority, and if those employees who have parking spaces constitute a fair cross-section of all employees, then the fair market value of the parking spaces provided would be excluded under the bill. On the other hand, if an employer provides free or reduced-cost parking only to highly compensated employees, the fair market value of the parking would not be excluded.

### *Recreational Facilities*

In general, the fair market value of any on-premises recreational facility provided and operated by an employer for its employees, where substantially all the use of the facility is by the employees (or their spouses or children), would be excluded under the bill for income and employment tax purposes. The recreational facility need not be in the same location as the business premises of the employer.

Under the bill, the employer's deductions with respect to the onsite recreational facility would be limited in computing the employer's taxable income. No limitation would apply to any deduction (such as for interest or taxes) allowable to the employer without regard to the deduction's connection to a trade or business. In the case of other facility expenses such as utilities, maintenance, depreciation, etc., the deductions could not exceed the amount of gross income from the property reduced by those deductions which are allowable regardless of their trade or business connection.

For example, if an employer provided and operated handball courts on its premises to be used free of charge by its employees, under the general rule the value of the use of these courts would be excluded from the employees' income and there would be no deduction allowed for expenses attributable to the facility and otherwise deductible only as trade or business expenses. Thus, if the employer incurred $500 in taxes, $1,000 in interest, and $4,000 in operating expenses, the only deductions allowed would be $1,500 ($500 for taxes plus $1,000 for interest). However, if the employer had charged employees or others a fee to use the courts, deductions could be taken up to the amount of the fees reduced by taxes, interest, and other deductions not affected by this provision. If, in the above example, $2,500 of fees had been collected, the employer could deduct $1,000 of the operating expenses ($2,500 minus $1,500) in addition to the $1,500 in taxes and interest.

At the employer's election, the exclusion under the bill with respect to recreational facilities would not be available to its employees; in that case, the deduction limitation would not apply to the employer. The election would be made for any taxable year in a time and manner as prescribed in Treasury regulations. Any election made generally would apply to all recreational facilities of the employer; the election would not be available on a facility-by-facility basis. Once made, an election could not be revoked without permission of the Internal Revenue Service.

### *Nonapplicability to Certain Fringe Benefits*

No fringe benefit would be excluded under the bill (other than a de minimis fringe) if another section of the Internal Revenue Code provides rules for the tax treatment of that general type of benefit. For example, the fair market value of day care services provided to an employee would be excludable only pursuant to the provisions of Code section 129. If in a particular situation such services do not qualify for exclusion under section 129 (because, e.g., the nondiscrimination requirements of that section are not met), no exclusion (other than the de minimis exclusion) would be available under the bill.

### *Qualified Tuition Reductions*

The bill would amend Code section 117 (relating to scholarship and fellowship grants) to exclude, for income and employment tax purposes, the amount of any reduction in tuition provided by an educational institution to its employee for the education at such institution of the employee (or of the employee's spouse or dependent children), if such benefits are made available to employees on a nondiscriminatory basis (see discussion above of nondiscrimination rules).

The exclusion would not apply with respect to tuition for education at the graduate level. No exclusion would be provided under the bill if an employee working for a school or college receives a reduction in tuition with respect to studies at a different educational institution.

The qualified tuition reduction provision of the bill would apply with respect to education furnished after June 30, 1984.

### *Cafeteria Plans*

The bill would amend the definition of cafeteria plans for purposes of Code section 125 to provide that such plans may offer employees choices only among cash or those fringe benefits (other than scholarships or fellowships, educational assistance, vanpooling, and those benefits excludable under provisions of the bill) that are excludable from gross income under a specific section of the Internal Revenue Code.

### *Effective Date*

The provisions of the bill generally would take effect on January 1, 1984, except that the tuition reduction exclusion would apply with respect to education furnished after June 30, 1984.

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Chairman **Stark**. Mr. Conable.

Mr. **Conable**. Mr. Chairman, since both you and I are prime sponsors of this measure, I think it is important that we both at the outset of the hearing, for the benefit of those understandably concerned about the direction of this legislation, make statements of what we had in mind at the time we put the bill in. That is my intention at this point. I want people to understand the circumstances that brought about H.R. 3525 and why we think it is important and timely.

I do not hold up the central bill before us as the full and final answer to longstanding problems. I don't consider it either a revenue-raising or a revenue-losing measure. I would, indeed, regret if the course of this committee were to be to try to raise revenue or lose revenue.

It does get to the very heart of tax equity and fairness and it is timely because we have delayed too long establishing a congressional policy with respect to the taxation of fringe benefits. There has been a vacuum which has existed for many years in the tax treatment of various fringes provided by employers to their employees. This vacuum exists largely because Congress failed to take decisive action on this issue. Instead, it imposed a moratorium since 1978 prohibiting the Treasury Department from issuing final regulations providing guidance in this area.

The combination of congressional action and Treasury Department immobility has prevented development of a clear, uniform set of rules to guide both employers and employees in the proper tax treatment of fringe benefits. One result has been that many benefits which are clearly subject to general rules of includability have not been taxed. Another result is that we have had the rules established on a patchwork basis by the various courts throughout the country with the result that some fringes are taxed in one part of the country and not in another part. That clearly is an intolerable and inequitable situation.

The importance of providing a uniform set of rules for taxation of fringes should not be understated and in fact becomes greater with each passing year. A number of factors support this conclusion. First, a continued lack of guidance with respect to the taxation of fringe benefits will permit continued erosion of the tax base as more and more employers provide noncash forms of compensation in the hope of avoiding includability in taxable income. Second, the absence of a uniform set of rules for taxing fringes imposes serious inequities within the system as taxpayers in different parts of the country are treated in a discriminatory manner with respect to identical or comparable forms of fringe benefit compensation as a result of court decisions.

Third, the untaxed status of fringe benefits encourages employers to provide noncash forms of compensation, thus restricting the employee's freedom of choice as to what their compensation may be used to purchase. Obviously take-home cash pay is the stuff of freedom since it can be used to buy anything while a fringe has to be spent entirely for the purpose of the fringe.

Four, the nontax status of certain fringe benefits creates inequities among various taxpayers because not all employers will provide comparable compensation packages.

The bill which is the subject of today's hearing provides a uniform set of rules for treatment of fringe benefits. In doing it, it accommodates many existing practices of employers. The bill does not modify the existing general rule of section 61 of the Internal Revenue Code which provides that all forms of compensation to an employee, whether in cash or noncash forms, are includable in gross income. Rather, it provides a series of exemptions from the general rule to clarify which items are not subject to the general rule of inclusion.

We should not approach this task with rigidity and I quite agree with the chairman in that respect. Nor should we ignore long-accepted practices. But we have waited too long to face what should be a responsibility of the Congress, not of the courts or the regulators.

I hope the Committee on Ways and Means will complete action on this important piece of legislation in the near future so that enactment by the end of the year can be achieved.

We look forward to hearing further from the Treasury Department in this respect. They felt they did not have time to come up with additional statements of their position today, but I know they are working on this subject and understand the seriousness and purpose of this subcommittee. I hope they will give us the benefit of their very large experience in this area.

It is difficult to overstate the importance of establishing a national policy for the taxation of fringe benefits. I am very pleased that the subcommittee has moved as vigorously as it has to have hearings on this important measure. I am pleased so many people are interested in it. I hope, as the chairman does, that the witnesses will approach this as an opportunity for creating reasonable and sound policy in an area which has been altogether too long neglected.

Thank you very much.

Chairman STARK. Thank you.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I have no prepared statement, but I do want to compliment you upon calling these hearings because it is a subject that has been before us for many, many years. It has not been the Treasury Department, I will say, that has requested extension through the years. It has been the members of this committee. I am hopeful we can come to some conclusion. We have always had the problem of determining what is a fringe benefit. In fact, it has been mentioned that the congressional Members' parking place is a fringe benefit which it really is, I guess. There are other things that we might have.

I think this bill takes off in the right direction to determine what is a fringe benefit and how it is applied. I look forward to hearing the testimony of the witnesses today. It is a good panel of witnesses in each instance and I know they will be most helpful.

Thank you, Mr. Chairman.

Chairman STARK. I thank the gentleman from Tennessee.

Now I call our first witness, a member of the committee, the Honorable Willis Gradison of Ohio.

Bill, we appreciate your appearance.

## STATEMENT OF HON. BILL GRADISON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. **Gradison**. Thank you, Mr. Chairman.

I do have a brief statement which is prepared. I want to thank you for giving me the opportunity to testify before this subcommittee. Since 1975, the Treasury has tried to issue regulations on fringe benefits. Its proposals have always created a furor.

Congress has reacted to the controversy by imposing moratoriums. Eventually, Congress must face up to the issue and define legislatively the tax treatment of fringe benefits. Failure to do so will, I believe, perpetuate and compound major inequities and uncertainties in our tax system.

H.R. 3525 is a sensible approach, and I commend the chairman and the subcommittee for their efforts. The bill delineates rationally a set of benefits that would be excluded from personal income tax.

There is, however, one important extension to this bill that I believe ought to be made. Over the years, Congress has excluded by statute about a dozen fringe benefits from taxation. Each was excluded for a good reason: Congress felt it desirable, from a public policy standpoint, to encourage employers to provide them. These statutorily excluded fringe benefits include, for example, health insurance, up to $50,000 of group term life insurance, legal services, and dependent care assistance.

I believe it is desirable to encourage the availability of these employee benefits. I question, however, whether Congress should encourage the use of these tax-free fringes without limit.

For example, it is good social policy to encourage employers to offer health benefits. However, there is abundant evidence that the failure to cap these benefits has had the unintended effect of helping make health care costs the most inflationary component of the economy over the past decade. The reason is that the present system has discouraged health care recipients from considering costs in selecting health care plans.

I believe there are alternatives, consistent with the bill, that would make our tax system fairer and more predictable. One alternative is to limit each statutorily excluded fringe. Group life insurance already has such a limit, as do death benefits.

I think a better approach would be to provide for each employee a single cap on the total value of all statutorily excluded fringes. Similar to a cafeteria plan, each employee would then choose from an array of tax-free fringes those he or she wants, and would pay tax only if the total value of those fringes exceeded the value of the cap on the entire basket. Placing a tax-free cap on aggregate, statutorily excluded fringe benefits would, in my judgment, complement the objectives of H.R. 3525.

I also believe that a cap could be set without significant revenue effects. Under an aggregate cap, some persons would find themselves with statutorily excluded fringes whose sum exceeds cap. The amount over the cap would be taxable income, so the short-term revenue impact would be positive. Over the longer run, people above the cap may decrease their fringes, and the resulting convergency toward the cap would mean revenue losses that would soon phase out.

Conversely, people below the cap would press their employers to provide more tax-free fringes. In this case, the short-term revenue impact is clearly zero, while over the longer run, there would be a transitory negative impact before that also phases out.

Because of the short- and long-term impacts, the dynamics are self-correcting. This means that a cap could be set that would have no significant revenue impact over a reasonable time horizon. Equally important, I believe a cap such as I have just described is doable, and that it would result in a more equitable and more predictable tax system for all Americans.

In conclusion, Mr. Chairman, I am well aware of the reluctance of the committee to go along with a cap, for example, on health insurance. I think, however, that if we had a cap on all currently nontaxable fringe benefits and set it at a reasonable amount, we could at least have the effect of giving employees a greater choice among benefits. In addition we would not make it possible as we do today for employees to look upon certain fringe benefits as equivalent to receiving a dollar and a quarter and other benefits as receiving dollar-for-dollar benefits.

Thank you, Mr. Chairman, for this opportunity to explore this concept.

If the subcommittee finds it at all interesting, we have been discussing it with members of the joint committee and perhaps they could carry the idea further if the subcommittee had any interest in seeing that done.

Chairman **Stark**. Thank you, Bill, for your contribution and taking the trouble to come and testify. Something that we have kicked around some is some sort of percentage cap. Would you go to a percentage of salary? Would you go to a flat dollar amount? Obviously if you take a flat limit, it hurts highly paid employees more. I wonder when you set the percentages, do you say your fringes can go to 20 or 25 percent of gross pay and no more or do you pick the fringes?

Mr. **Gradison**. My thinking would be to use a dollar limit. This would be far fairer to the average employee and provide less of a windfall benefit to highly compensated employees. While we have not talked about it a great deal, I think that examination of certain of these fringes that are currently nontaxable would disclose they are of special benefit to highly compensated employees. If that be the case, some kind of a reasonable dollar amount limit indexed if necessary to adjust for changes in the cost of the benefits provided, might be a fairer way to deal with the overall problem and to avoid slanting the whole system in the favor of highly compensated employees.

Chairman **Stark**. That would be a lot simpler than trying to figure out what is a fringe and what is a minimal cost and so forth.

Mr. **Gradison**. Yes. One of the benefits, Mr. Chairman, is that while we examine this issue in terms of those benefits currently offered, I think it is fair to say that this is an evolving field. There are new ideas that have been developed and others which will come along not contemplated today which will be affected in large part by the way in which we tax them. To the extent they all went into a basket and the tax were on the sum of the basket, it would make it possible for fringes to be provided to meet the needs of employees without necessarily being designed just to get around provisions of the tax laws or regulations.

Chairman **STARK**. Mr. Duncan.

Mr. **DUNCAN**. I have no particular questions other than to thank Mr. Frenzel for his always good testimony and help on all the legislation.

Chairman **STARK**. This is Mr. Gradison.

Mr. **DUNCAN**. Mr. Gradison—excuse me. This is Monday.

Mr. **GRADISON**. Our first names are close to the same.

Mr. **DUNCAN**. And I know you will continue to be helpful as we move from the subcommittee to full committee on markup. Thank you.

Mr. **GRADISON**. Thank you, Mr. Duncan.

Chairman **STARK**. Are there any questions?

Mr. Schulze.

Mr. **SCHULZE**. No questions.

Mr. **CONABLE**. No questions.

Chairman **STARK**. Thank you very much.

Mr. **GRADISON**. Thank you, Mr. Chairman.

Chairman **STARK**. The next witness is the Honorable Glenn Anderson, our colleague from California.

## STATEMENT OF HON. GLENN M. ANDERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. **ANDERSON**. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I appreciate having the opportunity to share with you today my views on the subject of fringe benefits or more precisely, airline fringe benefits.

At the outset, let me say I wholeheartedly agree with the thrust of H.R. 3525, the Permanent Tax Treatment of Fringe Benefits Act of 1983.

In these difficult times, when our country is faced with annual deficits in the range of $200 billion, we have the responsibility to establish reasonable guidelines to recoup billions in revenues lost under the guise of fringe benefits. As you well know, many corporations offer a terrific array of fringe benefits for their executives, and these can range from luxurious automobiles, memberships in exclusive clubs, stock gifts, free health and life insurance plans, and a host of other sweeteners. I feel we should go after these types of fringe benefits.

As you know, I have introduced H.R. 943 to amend the Internal Revenue Code of 1954 to exclude from gross income reduced airline fare benefits received by airline employees and their families.

Currently, this proposal has been endorsed by 25 of our colleagues.

I feel it would be very unfair to airline employees if their travel benefits were treated as gross income on which they must pay tax at the end of the year.

It is my understanding that there are two major differences between H.R. 3525 and H.R. 943 as it relates to airline fringe benefits. The first is that H.R. 3525 would prohibit interlining of flight passes vis-a-vis tax exemptions. Thus, if an employee of airline A uses a pass for airline B, for example, it would be treated as gross income. I strongly believe that current law should be extended which allows airline employees to fly at reduced rates on any carrier in which there are reciprocal agreements among the airlines and which are not treated as gross income.

Mr. Chairman, I am sure you know in most cases an airline employee is able to fly at a reduced rate only if a seat is available. Should the plane be full, they would remain grounded.

H.R. 3525 would exempt from taxable gross income tax privileges extended by an airline to its own employees and their immediate families. That is the spouse and the dependent children.

But it would not exclude from taxation those travel privileges extended by one airline to the employees of another airline. Quite frankly, I feel that if an employee of airline A flies in an empty seat on airline B, which could not be sold to the public prior to departure, it certainly does not burden airline B with any substantial additional cost.

Should H.R. 3525 be adopted in its current form, and, thus the taxation of interlining flight passes occurs, the question then arises how much is an empty seat on an airline flight worth?

As I am sure you are aware, all seats on an airplane are not the same price. As reported in the May 16, 1983, edition of the U.S. News and World Report, travelers flying between New York City and West Palm Beach could pay the following prices.

[The table referred to follows:]

| Air Florida | USAir | TWA | Delta | Pan Am | Eastern | Republic | People Express |
|---|---|---|---|---|---|---|---|
| $129 | $306 | $307 | $307 | $307 | $307 | $277 | $99 |
| 119 | 256 | 256 | 276 | 276 | 256 | 267 | 69 |
| 115 | 192 | 159 | 256 | 256 | 194 | 220 | |
| 104 | 158 | 150 | 192 | 150 | 192 | 210 | |
| 94 | 150 | 139 | 170 | 146 | 150 | 204 | |
| 83 | 112 | 128 | 150 | 139 | 139 | 186 | |
| | | | 139 | 128 | 99 | 158 | |
| | | | | 112 | | | |
| | | | | 104 | | | |

Mr. **Anderson**. As you can see, there were 8 airlines listed with 50 different prices involved. The prices run from a low of $69 to a high of $307. So I ask the question, how much is an empty airline seat worth?

The other major difference between H.R. 3525 and H.R. 943 applies to who can take advantage of these fringe benefits. H.R. 3525 states that only the immediate families of airline employees, that is spouse and children, will be permitted to fly at reduced rates without the value of the flight being treated as gross income. H.R. 943 takes this one step further and includes the parents of airline employees.

There are thousands of single airline employees out there today who vacation with their parents. Both fly at free or reduced rates. However, if H.R. 3525 is passed in its present form, this benefit would vanish. It would be unfair and inequitable to single employees, if their parents could no longer receive free or reduced airline fare benefits.

In closing, let me just again state that I agree with the basic thrust of H.R. 3525 and I would be more than happy to offer any assistance in working with you to iron out differences between it and H.R. 943.

Again, I congratulate you on your initiative. Thank you very much.

Chairman **Stark**. Thank you very much, Glenn.

You raise a question that has bothered many members of the subcommittee and the staff and I know the Treasury. That is, particularly in the airline case, how do you value, as you say, an empty seat? I suppose there is some modest marginal cost for the food and extra fuel, but other than that, I don't know how you arrive at it. It is something we have struggled with a long time.

Mr. **Anderson**. If you were going to tax their travel privileges, what would you tax? As I've just shown, there could very well possibly be some holding a ticket in excess of $300 and the person right alongside might be flying for under $100.

Chairman **Stark**. I suppose you do what happens to us, and that is whatever our limit is, you take the lowest coach fare available or the lowest fare available between two points and say that is the value, I guess. I don't know. That is—I think there has been some precedent for that treatment in the past.

But hopefully, after today's hearings that will all become clear to us.

Mr. **Anderson**. I hope so, too.

Chairman **Stark**. If there are no questions, we want to thank you very much.

We will now hear from a panel comprised of Mr. Edward Delaney of the Tax Section of the American Bar Association; Mr. Michael Walker, member of the Executive Committee of the Federal Tax Division of the American Institute of CPA's; Mr. Robert Odmark, Price Waterhouse; and Mr. Gerald Padwe, of Touche Ross & Co.

We have heard testimony from those of you who submitted it. Without objection, it will appear in the record in its entirety. We would appreciate it if you could summarize your testimony or additional information in about 5 minutes apiece and then we will try and have you elaborate on that part of the testimony that the committee would like you to expand on.

Unless you have some other way in which to proceed, I would call on Mr. Delaney.

## STATEMENT OF EDWARD N. DELANEY, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY THOMAS P. MARINIS, JR., ASSISTANT SECRETARY

Mr. **Delaney**. Thank you, Mr. Chairman.

I am Edward Delaney, currently chairman of the Tax Section of the American Bar Association. I am accompanied by Tom Marinis, our assistant secretary and the gentleman most responsible for putting together the American Bar Association position.

I want to say that the ABA strongly supports the intent and concept of H.R. 3525 to provide definitive and comprehensive legislation for the taxation of fringe benefits. We have been on record as favoring similar legislation since August 1980.

The taxation of in-kind economic benefits or fringe benefits received in connection with the performance of services has been a continual source of confusion and difficulty for our Federal income tax system. Although section 61 of the Internal Revenue Code describes gross income as all income from whatever source derived, in practice, many fringe benefits have escaped taxation simply as a result of uneven administration of the tax law and through reliance on the audit lottery.

In other cases, fringe benefits have been excluded based on an Internal Revenue Service administrative interpretation that the particular benefit was not taxable. This authority has generally constituted an ad hoc exercise of administrative discretion rather than the application of consistent underlying logical principles.

The absence of a clear statement of the principle that distinguishes taxable and nontaxable fringe benefits has fostered inconsistent administration of the statute. Too much has been requested of the discretion of the Internal Revenue Service field personnel during the audit process.

In some cases, the taxation of fringe benefits has received great emphasis in the audit process while in others the treatment of fringe benefits has not been raised and for cases where fringe benefits have been raised, it has not been unusual for the same benefit to be treated differently from one audit jurisdiction to another.

The resulting uncertainty has forced taxpayers to resort to speculative determinations in planning and reporting fringe benefits arising out of the performance of services. Further, similarly situated taxpayers are treated differently depending on whether or not the existing rules are being properly followed. While it is difficult to quantify the magnitude of the problem, there can be little doubt that the general state of confusion has contributed to the overall perception of unfairness and lack of confidence in our Federal tax system.

The negative impact on taxpayer confidence is far more significant than any revenue loss or gain associated with taxing or not taxing fringe benefits.

We adopted a legislative recommendation, including the language we would suggest which is attached to our report, which provides four general exclusions. The basic difference between the provisions that you have before you in your bill and our recommendation is that we would approach the issue on a much more general fashion. We would not identify specific fringe benefits since we think that that gives you a substantial problem in the political arena as well as in extensive complexity in the tax code.

We think that the provisions we have presented that use general definitions and based essentially on nondiscriminatory treatment will ease administrative burdens and will simplify the tax code considerably.

We also fully support your conclusion to tax fringe benefits based on fair market value rather than based on some other method of valuation.

Use of fair market value is a historic valuation method in the code, and while it does have complexities, there is a substantial history in its use and we would urge that that be followed in this instance.

We have pointed out a number of problems in H.R. 3525, as we perceive them, which you will see at length in our text.

I would like to refer to several of the problems.

One, in the definition of employee, we believe that you should expand that definition by giving the Secretary an opportunity, by regulation, to expand it to cover providers other than the direct employer. We would also point out that you should provide for a parity of treatment between common law employees and self-employed and independent contracts. It is not clear from your proposal whether it would apply to independent contracts, but it appears to us that it would apply only to common law employees. We think it ought to be expanded so that you have parity in treatment at all levels.

I would like to add one other concern that we have and that is with respect to the question of withholding at source. There is no apparent provision in the bill that there would or would not be withholding at source. We strongly urge that fringe benefits of this nature not be subject to the withholding at source rules.

Thank you.

Chairman **STARK**. Thank you, Mr. Delaney.

[The prepared statement follows:]

## STATEMENT OF EDWARD N. DELANEY, CHAIRMAN, SECTION OF TAXATION, ON BEHALF OF THE AMERICAN BAR ASSOCIATION

### SUMMARY

The American Bar Association strongly supports the intent and concept of H.R. 3525 to provide definitive and comprehensive legislation for the taxation of fringe benefits.

The taxation of fringe benefits has been a continual source of confusion and difficulty in our federal income tax system. There has been an uneven administration of the tax law, which has contributed to an overall perception of unfairness and a lack of confidence in the system.

In August 1980 the American Bar Association recommended the adoption of a legislative solution to the fringe benefit problem, which would preserve the existing treatment of most fringe benefits, but which also would satisfy the important tax policy objectives of simplicity, ease of administration and fairness, and would not provide for growing erosion of the tax base.

In most significant respects, H.R. 3525 parallels the existing proposal of the American Bar Association. The Association supports its enactment with certain changes, as set out in the Association's detailed statement.

### STATEMENT

My name is Edward N. Delaney of Washington, D.C., and I am Chairman of the Section of Taxation of the American Bar Association. I appear before you today to present the views of the American Bar Association on H.R. 3525 and the taxation of non-statutory fringe benefits.

The American Bar Association strongly supports the intent and concept of H.R. 3525 to provide definitive and comprehensive legislation for the taxation of fringe benefits. The Association has been on record as favoring similar legislation since August, 1980.

The taxation of in-kind economic benefits or "fringe benefits" received in connection with the performance of services has been a continual source of confusion and difficulty for our federal income tax system. Although section 61 of the Internal Revenue Code defines "gross income" as all income from whatever source derived, in practice many fringe benefits have not been taxed. In many instances, these benefits have escaped taxation simply as a result of uneven administration of the tax law and through reliance on the audit lottery. In other instances, benefits have been excluded based on an Internal Revenue Service administrative interpretation that the particular benefit was not taxable. This authority has generally constituted an ad hoc exercise of administrative discretion rather than the application of consistent underlying logical principles.

The absence of a clear statement of the principles that distinguish taxable and nontaxable fringe benefits has fostered inconsistent administration of the statute. Too much has been requested of the discretion of the Internal Revenue Service field personnel during the audit process.

In some cases, the taxation of fringe benefits has received great emphasis in the audit process, while in others the treatment of fringe benefits has not been raised. In cases where fringe benefits have been raised, it has not been unusual for the same benefit to be treated differently from one audit jurisdiction to another. The resulting uncertainty has forced taxpayers to resort to speculative determinations in planning and reporting benefits arising out of the performance of services. Further, similarly situated taxpayers are being treated differently depending on whether or not the existing rules, such as they are, are being properly followed. While it is difficult to quantify the magnitude of the problem, there can be little doubt that the general state of confusion and uncertainty has contibuted to an overall perception of unfairness and lack of confidence in our federal tax system. The negative impact on taxpayer confidence is far more significant than any revenue loss or gain assoicated with taxing or not taxing fringe benefits.

It was with these policy considerations in mind that the Association recommended, after a comprehensive study by the Tax Section, that Congress adopt legislation resolving the tax treatment of fringe benefits. By way of background, the ABA proposal establishes a general rule that a fringe benefit is to be included in gross income unless it is covered by one of four exclusionary rules. First, a fringe benefit would be excludable from gross income if (a) it is incident to the employer's trade or business, (b) it is provided on a nondiscriminatory basis, and (c) the marginal or incremental cost of providing the benefit is insubstantial. Second, a fringe benefit would be excludable from gross income if it is provided primarily for the benefit of the employer rather than the employee. Third, insubstantial fringe benefits would not be includable in gross income if they are not provided on a frequently recurring basis. And finally, there is aspecial rule that provides that the value of certain employer-furnished recreational facilities are excluded from gross income when the costs of furnishing such facilities qualify for deduction under existing rules. If a fringe benefit does not meet one of the four standards for exclusion, the amount includable in gross income would be equal to the excess of the fair market value of the benefit over the amount paid for the benefit by the recipient. A copy of the ABA resolution, together with an explanatory report and suggested statutory language is attached to the statement. Included in the attachment is a memorandum analyzing the impact of the ABA proposal on specific fringe benefits.

Like the ABA proposal, H.R. 3525 responds to these important policy issues by providing a comprehensive and definitive set of rules for the taxation of non-statutory fringe benefits. Importantly, H.R. 3525 recognizes that resolution of the fringe benefit issue is complicated by long-standing administrative interpretation and unchallenged or widely held perceptions that particular benefits are not taxable. It confirms the nontaxability of many traditional fringe benefits. This is both realistic and fair and has the Association's strong endorsement. In addition, the Association enthusiastically supports the decision to tax includable fringe benefits at their fair market value, as opposed to either marginal or allocable cost. While there may be some difficulties in ascertaining fair market value in certain specific instances, these difficulties will also be present under cost valuation. Use of fair market value on the other hand is consistent with the overall approach to valuation under the Internal Revenue Code. It may, however, be appropriate for the Secretary to issue additional regulations for determining fair market value.

Although H.R. 3525 is similar to the ABA proposal, and achieves parallel results in most instances, there are also important differences in the two approaches. In the remainder of this statement, I will discuss certain specifics of H.R. 3525 and focus on these differences. There are also several technical matters that may require further attention.

### *No-additional-cost service*

H.R. 3525 would exclude from gross income the value of any "no-additional-cost service" provided by an employer for the use of an employee. In order to qualify, the service must be provided to the employer's customers in the ordinary course of business and must be provided to the employees on a nondiscriminatory basis at no substantial additional cost to the employer.

This exclusion is similar in result to the ABA proposal for exclusion of nondiscriminatory benefits that are incident to the employer's trade or business and are available without any substantial marginal or incremental cost to the employer. However, the rule of H.R. 3525 is more narrow in that the exclusion is limited to services that are provided to customers in the ordinary course of an employer's business. The Technical Explanation makes it clear that incidental use of corporate assets, such as cars or airplanes, by employees would not be eligible for exclusion, even when such use is on a nondiscriminatory basis and without substantial cost to the employer.

The policy determination supporting this exclusion is a conclusion that it is inappropriate to impose a tax based on prevailing market values on an employee who simply avails himself of goods or services that are available because of the nature of the employer's business. In many such cases the decision to utilize or forego such a benefit is casual and sporadic. The subjective value of the fringe benefit to the employee may be substantially less than its objective market value. The foregoing considerations are equally applicable whether or not the service provided the employee is offered to customers in the ordinary course. We urge the Subcommittee to follow the ABA proposal and expand the coverage of the "no-additional-cost service" to include incidental use of all corporate assets and facilities, provided the no-additional-cost and nondiscrimination requirements are satisfied.

H.R. 3525 provides that the determination whether the employer incurs substantial additional cost shall be made without regard to any amount paid by the employee for the service. The rationale for this limitation is not clear, and it seems inappropriate to prohibit the availability of this exclusion in circumstances where the employer charges its employees a fee in order to recover its out-of-pocket costs.

### *Qualified employee discounts*

H.R. 3525 excludes from gross income the value of all nondiscriminatory "qualified employee discounts" with respect to goods and services offered to customers in the ordinary course of business, provided the discount does not exceed the lower of 20 percent or the employer's profit percentage. This exclusion is supported by the same policy conclusion that supports the "no-additional-cost service" exclusion.

While the statutory limitation of the lower of 20 percent or the employer's profit percentage will tend to prevent abuses, the same result could be accomplished more simply by requiring that the discount be provided at "no substantial additional cost" to the employer, as is the case with the "no-additional cost-service" exclusion. This marginal cost test would result in the employer recovering its cost, which is the objective of the H.R. 3525 limitation. Use of this latter test would also permit combining the "no-additional-cost service" and "qualified employee discount" exclusions into the single exclusionary rule used in the ABA proposal. In addition, we recommend that the Subcommittee change the requirement that the goods and services eligible for discounts be offered by the employer to customers in the ordinary course of its business to the broader requirement that the goods be offered or available "incident to" or "in connection with" the employer's business. There may be circumstances where an employer, because of the nature of its business, finds it necessary to operate a company store, which offers employees goods and services that are not otherwise offered to the employer's customers. A military commissary is a good example. It seems appropriate to treat discounts from fair market value at these facilities the same as discounts on goods and services offered to the employer's customers.

### *Working condition fringe*

H.R. 3525 excludes from gross income the value of "working condition fringe" benefits, which are defined as property or services provided primarily for the benefit of facilitating the employee's performance of services. This exclusion is essentially the same as the ABA "benefit-of-the-employer" rule and recognizes as its policy basis the fact that the derivation by an employee of some incidental personal benefit or enjoyment from what is essentially a condition of his job should not result in gross income to the employee.

To qualify for exclusion, H.R. 3525 requires that "substantially all" of the use of property or services occur in connection with the employer's business. The Technical Explanation makes it clear that "substantially all" means 85 percent or more and suggests that 15 percent or less personal use of a company automobile would be excludable from gross income under the "working condition fringe" exclusion, presumably without regard to the circumstances of such use. While there are difficulties associated with attempting to tax the incidental personal use of "working condition" fringe benefits, these difficulties do not occur in the case of personal use of company automobiles. Such use is clearly apportionable from the business use and its value may be accurately measured. Accordingly, the ABA would not interpret its own proposal to exclude personal use of company automobiles unless such personal use was made available to employees on a nondiscriminatory basis at no substantial additional cost to the employer. In this regard, the ABA proposal would treat this latter requirement as being satisfied where the employee reimbursed the employer for the marginal cost of the personal portion of the automobile use. We recommend modification of either H.R. 3525 or the Technical Explanation to provide that apportionable personal use of a working condition fringe is taxable.

### *De minimis fringes*

Like the ABA proposal, H.R. 3525 recognizes that the cost to employers and employees of accounting for benefits of nominal value and the cost to the government of enforcing the policy of inclusion of such benefits is not justified in view of the small amount of additional tax revenues involved. Accordingly, H.R. 3525 excludes from gross income de minimis benefits that are so small as to make accounting for them unreasonable or administratively impractical.

The statutory language states that in apply the de minimis fringe exclusion all "small-valued property or services" shall be aggregated. An aggregation rule defeats the purpose of a de minimis exclusion by making it necessary to account for all benefits of nominal value to determine whether the aggregate limitation has been exceeded. We recommend that there be no aggregation rule that would require accounting for items of small value. Further, we recommend, as provided in the ABA proposal, that some objective definition of "small value" be provided either in the statutory language or the Technical Explanation. The ABA proposal provides that a benefit would be considered to be of nominal value, and thus nontaxable, if its fair market value either is not more than $50 or the value is not known, but is so small as to make accounting for it unreasonable or impractical. Finally, the ABA proposal recommends that a benefit could not be provided on a frequently recurring basis and remain exempt under the de minimis rule.

### *Use of special rules of exclusion.*

In addition to its general rules of exclusion for no-additional-cost service benefits, qualified employee discounts, working condition fringes and de minimis fringes, H.R. 3525 provides special rules of exclusion for demonstrator automobiles used by automobile salesmen, free parking, on-premises recreational facilities, and qualified tuition-reduction programs. The ABA proposal on the other hand has only one special rule for employee recreational facilities as defined in section 274(e)(5) of the Code. While providing for the specific treatment of particular benefits makes it possible to draft general rules more narrowly and arguably results in greater certainty of treatment with respect to particular benefits, it also greatly increases the complexity of the statute. In addition, it does not seem appropriate to single out particular benefits for exclusion when other generically similar benefits now or hereafter provided are not excluded. Furthermore, opening the statute to itemization of particular benefits that are excludable from gross income may be an invitation for special interests groups to advocate expansion of the itemized list, with resulting confusion and complexity. For these reasons, the ABA position has been that any new legislation on the taxation of fringe benefits be limited to an expression of general rules of inclusion and exclusion. Except for recreational facilities defined in section 274(e)(5), no specific benefits are singled out for special treatment. In this regard, we should point out that under the ABA proposal, tuition-reduction would be nontaxable, if provided on a nondiscriminatory basis at no substantial additional cost to the university. We recognize that there is merit in providing for tuition reduction in section 117 because of its close relationship to scholarships, and for that reason we do not oppose a special rule for tuition reduction by itself. On the other hand, under the ABA proposal, personal use of "demonstrator" automobiles by automobile salesmen probably would be taxable, as it is under present law, at least in those circumstances where the salesmen are not required to pay for the marginal cost of their personal use. The same would be true of free parking, except to the extent of parking in remote locations and parking privileges of only a nominal value.

### *Definition of employee*

H.R. 3525 defines "employee" for purposes of the exclusionary rules to include spouses and dependent children and retired and disabled employees. The ABA proposal would reach a similar result by different statutory language. In addition, the

ABA proposal recommends providing additional flexibility in the definition of eligible recipients of nontaxable fringe benefits, by granting the Secretary authority to prescribe by regulations the extent to which the term "employer" shall be limited to a particular business of the employing person or expanded to include persons related to the employing person within the meaning of section 482 or persons engaged in the same or a related trade or business as the persons for whom services are performed under an agreement or established practice. This flexibility was considered desirable in order to permit the Internal Revenue Service to deal with particular situations and proposed reciprocal arrangements between employers on a case-by-case basis without the necessity for complex statutory language. Under H.R. 3525, reciprocal arrangements, other than arrangements between a department store and its lessees, would be prohibited. If the ABA approach were adopted, the complex statutory provisions for employees of leased sections of department stores would be unnecessary, as such facilities could be provided for under the Secretary's regulatory authority.

*Parity*

There is nothing in H.R. 3525 or the Technical Explanation regarding whether H.R. 3525 is intended to apply to self-employed persons. The new rules appear to be restricted to common-law employers and employees. Consistent with the strong ABA policy on parity of tax treatment between self-employed and corporate employees the ABA proposal would apply to any fringe benefit provided in connection with the performance of services, not merely to benefits provided by an employer for its common-law employees. This broader ABA proposal is consistent with the Congressional policy reflected in the TEFRA (Tax Equity and Fiscal Responsibility Act of 1983) for increased parity between employees and self-employed persons. We strongly recommend that approach to the capital Subcommittee in developing these fringe benefits rule.

*Recreational facilities*

H.R. 3525 would deny the employer deductions for the cost of providing on-premises recreational facilities (other than deductions for interest and taxes and any other cost to the extent of any income from the facility) to the extent that the value of an employee's use of such facilities is excludable from gross income. The employer may elect to deduct such expenditures, in which event, the fair market value of the employee's use would become includable in gross income.

The ABA proposal also provides for the exclusion from gross income of the value of recreational facilities provided by an employer to this employees on a nondiscriminatory basis. We reached this conclusion primarily on the basis that section 274(e)(5) had previously singled out these facilities for special treatment in determining the employer's deduction. It seem appropriate also to provide for special treatment in determining the tax consequences of their receipt. We continue to believe that this is the case, but we question whether there is sufficient basis in either equity or protection of the revenue to justify the complexity associated with the no-deduction rule on the employer side, particularly when it is combined with an election to tax the employee. Accordingly, we recommend that the employer not be denied a deduction for recreational facilities, provided the facilities are made available to the employees on a nondiscriminatory basis. In addition, the Subcommittee may wish to consider coordinating this exclusion with existing section 274(e)(5), as was done in the ABA proposal.

*Withholding at source*

While the ABA has not adopted a formal position on withholding questions that arise in connection with fringe benefits, the Tax Section believes that any legislation that is adopted should address withholding at source, and provides specific and objective tests for employers to follow. The report accompanying the ABA proposal recommends that there be no withholding on end-kind fringe benefits, but that there be increased information reporting and increased penalties for failures to report.

* * * * * * *

The existing Congressional moratorium on new fringe benefit regulations expires December 31, 1983. Legislation along the lines of H.R. 3525, as modified by the recommendations that we have made in this statement, should be enacted at the earliest possible date in order to make a further extension unnecessary.

Mr. Chairman, we appreciate the opportunity we have had to participate in these hearings. The ABA Tax Section is available to provide assistance and technical advice to the Subcommittee as it proceeds on the important task of considering providing for the taxation of non-stuatutory fringe benefits.

## APPENDIX A

## TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO SET FORTH RULES FOR THE TAXATION OF FRINGE BENEFITS

### RESOLUTIONS

*Resolved* that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to provide (1) that the value of a fringe benefit shall be excluded from gross income if (a) the benefit is incident to the employer's business and is provided on a nondiscriminatory basis at no substantial marginal cost, (b) it is provided primarily for the benefit of the employer, (c) the expense of supplying the benefit is excepted from the requirements of section 274(a) by section 274(e)(5), or (d) it is not provided on a frequently recurring basis and its fair market value is either not more than fifty dollars or is so small as to make accounting for it unreasonable or administratively impractical; and (2) that the excess of the fair market value of a taxable fringe benefit over the amount paid therefor shall be included in the gross income of the individual who performed the services on account of which the benefit was made available;

*Further Resolved* that the Section of Taxation is directed to urge on the proper committees of the Congress amendments which will achieve the foregoing results.

### REPORT

*Summary*

Although section 61 broadly defines gross income as all income from whatever source derived, certain kinds of benefits arising out of the employment relationship traditionally have not been reported as gross income. Various Code provisions, regulations, rulings, and court decisions provide authority for the omission of some of these benefits from gross income. Many benefits, however, are not the subject of any specific authority, and this lack of authority has resulted in inconsistent treatment of similar items by the Internal Revenue Service.

It is recommended (1) that taxpayers be permitted to exclude from gross income the value of a fringe benefit if (a) the benefit is incident to the employer's business and is provided on a nondiscriminatory basis at no substantial marginal cost, (b) it is provided primarily for the benefit of the employer rather than the employee, (c) the expense of supplying the benefit is excepted from the requirements of section 274(a) by section 274(e)(5), or (d) it is provided only infrequently and its fair market value is either not more than fifty dollars or is so small as to make accounting for it unreasonable or impractical; and (2) that the amount includible in gross income with respect to a taxable fringe benefit be determined by reference to the fair market value of such benefit.

*Discussion*

Section 61 broadly defines gross income as "all income from whatever source derived, including . . . [c]ompensation for services, including fees, commissions, and similar items." Moreover, Reg. § 1.61-2(d)(1) provides that property or services received as compensation must be included in income at fair market value. This language has been cited by the service and the courts in determining that various employee fringe benefits constitute income to the recipient. See, e.g., *Silverman* v. *Commissioner,* 253 F.2d 849 (8th Cir. 1958) (wife's expenses on foreign trip); *Vierling, Jr.* v. *Commissioner,* T.C. Memo 1969-116 (automobile); *Bell Electric Co.* v. *Commissioner,* 45 T.C. 158 (1965), *acq.* 1966-2 C.B. 4 (trips abroad for sales performance).

Congress has by statute excluded from gross income certain economic benefits received by employees as a result of the employment relationship. Examples of such nontaxable benefits include group term life insurance coverage, employer provided health insurance, meals and lodging furnished for the convenience of the employer, and group legal services plans. Sections 79, 105, 119, and 120.

In addition, and notwithstanding the broad language of section 61 and the regulations thereunder, other items of economic benefit received by employees as a result of the employment relationship traditionally have not been classified as gross income even though there is no applicable statutory exclusion. For example, the Service ruled in 1921 that passes issued by a railroad company to its employees and their dependents, to be used when not on company business, did not result in gross income. O.D. 946, 4 C.B. 110 (1921). In Rev. Rul. 59-58, 1959-1 C.B. 17, the Service ruled that merchandise of nominal value, such as turkeys, hams, and similar items, could be distributed as Christmas gifts by an employer to his employees without income tax consequences to the employees. It has also been held that the recipient of a low-interest or interest-free loan from his employer is not in receipt of gross income. *Dean* v. *Commissioner,* 35 T.C. 1083 (1961), *nonacq.* 1973-2 C.B. 4; *Zager* v. *Commissioner,* 72 T.C. No. 82 (Sept. 5, 1979); *Creel* v. *Commissioner,* 72 T.C. No. 97 (Sept. 25, 1979). (For the sake of convenience, references in this discussion to "fringe benefits" relate only to those benefits which are not specifically dealt with by statute under present law.)

The absence of a clear statement of the principles which distinguish taxable fringe benefits from those which are not taxable has resulted in inconsistent administration of the statute. In some cases the taxation of fringe benefits has received great emphasis in the audit process, while in others the question of fringe benefits has not been raised. The uncertainty caused by the absence of guidelines and the uneven administration of the statute forces taxpayers to resort to speculative determinations in planning and reporting benefits arising out of the performance of services.

The question of fringe benefit taxation has drawn increasing interest during the last four years from both the executive and legislative branches of government. In September, 1975, a "discussion draft" of proposed regulations relating to the taxation of fringe benefits was published in the Federal Register. 40 Fed. Reg. 41118 (1975). These draft regulations were described as an attempt to rationalize the existing treatment of fringe benefits and to provide additional rules for the future. In general, the discussion draft would have continued the tax exempt status of a number of fringe benefits, but would have required taxation of certain benefits which are typically provided at the executive level and involve substantial amounts.

No action was taken with respect to the discussion draft until December, 1976. At that time, the Service submitted a package of draft revenue rulings dealing with the fringe benefit question for Treasury Department review. The draft revenue rulings would have represented a significant departure from the direction taken in the discussion draft of proposed regulations. The revenue rulings were never issued, and the discussion draft was withdrawn.

In March, 1977, the Commissioner of Internal Revenue stated that proposed regulations dealing with fringe benefits would be issued the following summer. As a result, a number of bills intended to prevent the Service from issuing regulations or rulings concerning fringe benefits were introduced in the Congress. No fringe benefit regulations or rulings were issued, presumably as a result of the expressed congressional interest, and the freeze was formalized in Pub. L. No. 95-427 (Oct. 7, 1978), which initially prohibited the issuance of (1) final regulations before January 1, 1980, or (2) proposed or final regulations which have an effective date before January 1, 1980, on the subject. The freeze was extended until June 30, 1981 by Pub. L. No. 96-167 (Dec. 29, 1979).

Congressional interest in the subject of fringe benefits was also evidenced by the creation of a Task Force on Employee Fringe Benefits by the Ways and Means Committee in June, 1978. The Task Force went out of existence on January 2, 1979, without making any specific recommendations; however, the Task Force did submit a discussion draft and report prepared by its staff to the Chairman of the Ways and Means Committee. Under this staff report, a fringe benefit would be excludible from income if it met any one of several tests, including (1) a "convenience of the employer" test, (2) a de minimis test, or (3) a "general guidelines" test involving nondiscrimination, marginal costs, and value received by the employee.

In April of 1979, the Federal Taxation Division of the American Institute of Certified Public Accountants (AICPA) published "Fringe Benefits: A Proposal for the Future," recommending that legislation be enacted to exclude from taxation benefits which exist incidentally to an employer's business and which are provided to employees on a nondiscriminatory basis at no substantial additional cost to the employer. In addition, the AICPA proposal would exclude from taxation de minimis benefits, as well as benefits which (1) are considered part of the working conditions and have a proximate relation to work performed, (2) accommodate an important business requirement of the employer, or (3) are provided primarily to insure the employee's safety. If a fringe benefit is includible in income, the AICPA proposal recommends that it be valued at the lower of its incremental cost or fair market value. However, if the benefit is provided primarily for the personal use of the employee, allocated cost would be substituted for incremental cost. The AICPA proposal would apply only to common-law employees and not apply to independent contractors or partners.

The Recommendation has been prepared with the conviction that, although reasonable opinions differ greatly on how best to treat fringe benefits, the American Bar Association ought at this time to play a part in the current process of developing new rules in the area. The underlying principle of the Recommendation is that not all items of economic benefit received in connection with the performance of services should be considered gross income for tax purposes. Notwithstanding the broad language of section 61 and certain statements made by the Supreme Court in such cases as *Commissioner* v. *Smith*, 324 U.S. 177 (1945), there appears to be general agreement among those who have considered the subject that some items received in the employment context should be excluded from gross income. The Recommendation represents an effort to distinguish between taxable and nontaxable fringe benefits on a basis which meets the objectives of simplicity, ease of administration, and fairness. The existence of long-established practices with respect to certain fringe benefits has also been given major weight in developing the Recommendation, primarily in cases where an abrupt departure from such a practice might be especially unfair to taxpayers who might have relied upon the established tax treatment of those benefits.

The Recommendation establishes a general rule under which a fringe benefit would be included in gross income unless it is covered by one of four specific exclusionary rules and prescribes the method of valuing includible fringe benefits. Under the first exclusionary rule, a fringe benefit would be excludible from gross income if it is incident to the employer's trade or business, it is provided on a nondiscriminatory basis, and the marginal cost of providing the benefit is insubstantial. Second, a fringe benefit would also be excluded from gross income if it is provided primarily for the benefit of the employer rather than the employee. Third, a fringe benefit would be excludible from gross income if the expense of supplying the benefit is excepted from the requirements of section 274(a) by section 274(e)(5). Finally, the value of a fringe benefit would not be includible in an employee's gross income if the benefit is of insubstantial value and is not provided on a frequently recurring basis.

If a fringe benefit does not meet one of the standards for exclusion, the amount includible in gross income would equal the excess of the fair market value of the benefit over the amount paid therefor.

The first exclusionary rule established by the Recommendation is for benefits which are incident to the employer's trade or business and are available without any substantial marginal cost to the employer. The underlying rationale for this exclusion is that it is inappropriate to impose a tax based on prevailing market values on an employee who simply avails himself of goods or services which are available because of the nature of the employer's business. In many such cases the subjective value of the fringe benefit to the employee is substantially less than its fair market value, and the principal effect of imposing a tax on the basis of the fair market value of such a benefit is to discourage employees from enjoying the benefit. A benefit not incident to the employer's business, however, is clearly much more likely to be intended as compensation, and is also more likely to be provided as a result of pressure from employees to whom the subjective value of the benefit more closely approximates its fair market value. The potential for abuse of this exclusion is limited by the requirement that the marginal cost incurred by the employer in providing all such benefits may not be substantial in relation to the total cash compensation paid to all employees eligible to receive the benefits and by the requirement that the benefit be made available on a nondiscriminatory basis.

An employee's receipt of a service provided by an employer is considered incident to the business of the employer if such service is provided primarily to persons dealing with the employer in the ordinary course of its business, or if it is available because it is necessary or appropriate to the accomplishment of the employer's business objectives. An employee's receipt or use of a good or a facility made available by an employer is considered incident to the employer's business if such good or facility is owned or controlled by the employer for purposes necessary or appropriate to the conduct of its trade or business rather than primarily for the personal benefit of employees. Whether a fringe benefit is incident to the business of the employer is, of course, a question of fact to be determined on a case-by-case basis.

The marginal cost of a fringe benefit is the incremental cost incurred by the employer in providing the benefit. Stated another way, the marginal cost of a fringe benefit is the cost incurred by the employer which would not have been incurred but for the fact that the benefit was provided. The marginal cost of a fringe benefit does not include any loss of revenue actually or potentially suffered by the employer as a result of providing the benefit. In accordance with generally accepted principles of economics and accounting, fixed costs are not ordinarily included in the computation of the marginal cost of a fringe benefit. Instead, marginal cost is determined by reference to the variable (or direct) costs associated with the fringe benefit, under regulations to be developed by the Service. Fixed costs are, however, included in determining the marginal cost of an inventory item provided to an employee as a fringe benefit if such costs are included in the cost of inventory pursuant to the method of accounting used by the employer for tax purposes.

Even though a benefit is incident to the employer's trade or business, it would not be excluded from gross income under the Recommendaiton unless it is made available to a reasonable classification of individuals established by the employer. The establishment of reasonable classifications would be permitted in recognition of the fact that it may be inappropriate to make certain benefits available to all individuals. Whether a classification is reasonable would be judged by reference to all the facts and circumstances, but it is expected that such factors as age, length of service, and job classification may be taken into consideration. A classification would not be considered reasonable, however, if its effect would be to discriminate in favor of officers, shareholders or other owners, or highly compensated individuals.

Items provided primarily for the benefit of the employer rather than that of the employee would be excluded from gross income because such items are generally not compensatory in nature. The fact that an employee might derive some incidental personal benefit or enjoyment from such a benefit should not result in its value being included in his gross income.

Whether a fringe benefit is provided primarily for the benefit of the employer is a question of fact which would require an analysis of all of the circumstances under which the benefit is provided. No single fact or combination of facts would be conclusive. Among the factors that should be taken into consideration are whether the benefit is available to a broad cross-section of employees, is basically a condition of employment, and whether the benefit is intended primarily to facilitate the accomplishment of the employer's business objectives other than the objective of paying compensation.

The proposed statutory language does not enumerate specific benefits covered by the benefit-of-the-employer rule. A number of benefits, however, are believed generally to fall within the scope of the exclusion. For example, the provision of bodyguards and transportation to and from job sites through dangerous areas would be nontaxable to the employee because of the employer's need to protect its personnel. Employment agency fees paid by an employer would be nontaxable because such fees are intended not as compensation to the employee, but instead as compensation to the employment agency for providing the employer with necessary employees. Supper money provided by an employer for employees who occasionally work abnormal hours would be considered nontaxable because it is provided primarily to secure needed services at an unusual hour, rather than to compensate the employee for such services. The value of employer-provided training and education which is job-related would be excludible from gross income because such benefits are provided by the employer primarily to improve the conduct of the employer's business.

The third exclusionary rule under the Recommendation is that any benefit exempt from the requirements of section 274(a) by section 274(e)(5) would not be included in gross income. Section 274(a) generally disallows a deduction for any expense incurred in connection with activities involving entertainment, amusement, or recreation, unless the taxpayer establishes a close relationship between the expenditure and his trade or business. With certain exceptions, expenditures incurred for a facility used in connection with such an activity are disallowed without regard to the relationship between the use of the facility and the employer's business. Section 274(e)(5), however, exempts from the rules of section 274(a) expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees. In order to come under the ambit of section 274(e)(5), the activity or facility must primarily benefit those employees who are not officers, shareholders or other owners, or highly compensated individuals. In view of the fact that these benefits have previously been singled out for special treatment in determining the employer's deduction, it is deemed appropriate also to provide for special treatment in determining the tax consequences of their receipt.

Benefits of nominal value would be excludible from gross income because the cost to employers and employees of accounting for such benefits and the cost to the government of enforcing a policy of inclusion is not justified in view of the small amount of additional tax revenue involved. There is widespread agreement that such an exclusion is both necessary and appropriate, and the only disagreement concerns the details of such an exclusion. Under the Recommendation, a benefit would be considered to be of nominal value, and thus nontaxable, if its fair market value either is not more than fifty dollars or is so small as to make accounting for it unreasonable or administratively impractical. In order to prevent abuse, the Recommendation also provides that a benefit cannot be provided on a frequently recurring basis and remain exempt under the de minimis rule. Consideration was given to the imposition of an aggregate annual limitation of five hundred dollars for de minimis benefits, but this approach was rejected because it would have defeated the purpose of the de minimis exclusion by making it necessary to account for all benefits of nominal value to determine whether the aggregate limitation had been exceeded. Of course, whether a benefit is provided on a frequently recurring basis during the taxable year is a question of fact which must be determined on a case-by-case basis.

A number of other possible exclusions were considered but were omitted from the final text of the Recommendation. A proposed exclusion for benefits tending to promote socially desirable objectives was omitted because of the difficulty of defining which objectives would fall within it. An exclusion for such benefits as might be specified in regulations to be issued by the Secretary was omitted because of the belief that it would constitute an inappropriate delegation of legislative authority to the executive branch.

A fringe benefit that does not fall within one of the four categories of excludible benefits discussed above would be includible in gross income.

The selection of a valuation method to determine the amount includible in gross income has proved the most controversial aspect of the subject of taxation of fringe benefits. The two methods with the firmest theoretical and practical foundation are marginal cost and fair market value.

Marginal cost has not been in general use as a method of valuation for tax purposes. In the case of subsidized employee cafeterias, however, the Service has assessed deficiencies based on gross income measured by the excess over receipts from employees of the cafeteria's costs of operation, rather than by the excess over receipts of the fair market value of meals served. Although it cannot be said that marginal cost is always easily determinable, it may, in some cases, be easier than fair market value to determine objectively. In most instances cost information is readily available from an employer's books and records. The ability to make an objective determination is particularly important to the employer, since it is the employer who must implement any withholding or reporting requirements applicable to a fringe benefit. The cost to an employer of providing a fringe benefit is, moreover, especially relevant to the question whether the benefit is more in the nature of a nontaxable gift than taxable compensation, since in determining whether to make a gift to employees, the employer is likely to be more concerned with the cost incurred than with the economic value of the benefit to the employee. Moreover, if an item can be provided at little or no cost it is less likely to be compensatory in nature.

The determination of "fair market value," on the other hand, is often difficult and frequently results in controversy and litigation. The fact that many fringe benefits have no close counterpart in the marketplace simply aggravates the difficulty of determining fair market value. The use of a fair market value standard of valuation, however, has the virtue of being consistent with the method traditionally applied for most other purposes under the Code. To the extent that receipt of a fringe benefit is equivalent to the receipt of cash compensation, the imposition of a tax based on the amount that the recipient would have to pay for the benefit on an arm's-length basis is not unfair. Applying a fair market value standard usually results in a higher taxable amount than applying a marginal cost standard.

Recognizing that persuasive arguments can be made in support of either the fair market value method or the marginal cost method, and giving due consideration to the objectives of ease of administration, consistency with other Code provisions, and fairness among taxpayers, the Recommendation provides that a fringe benefit would be valued at fair market value both for purposes of determining whether the benefit is excludible under the de minimis rule and for purposes of determining the amount includible in gross income with respect to a taxable fringe benefit.

The Recommendation provides that an employee or his beneficiary must actually receive a fringe benefit in order to be taxable with respect to it. Accordingly, an employee would not be deemed to be in constructive receipt of gross income simply because a fringe benefit was available; rather, he would have to make use of the benefit before he would be required to report additional gross income.

The Recommendation would apply to any fringe benefit provided in connection with the performance of services, not merely to benefits provided by an employer for its common-law employees. Thus, benefits received by an independent contractor would be taxable in accordance with the principles of the Recommendation, as would be any benefits received by the family or friends of the individual who performed services for the employer which provided the fringe benefit. Such treatment is, of course, consistent with the principles of section 83. The Recommendation would also apply, under regulations to be issued, to benefits provided by an employer to employees of another employer in the same or a related industry under an agreement or established practice. In addition, the Recommendation provides for the issuance of regulations determining the extent to which the term "employer" shall be limited to a particular business of the employing person "such as a division" or expanded to include persons related to the employing person within the meaning of section 482.

The Recommendation would also apply to a fringe benefit received by a partner from his partnership. Regulations should be issued to clarify the fact that an includible fringe benefit is to be treated as a guaranteed payment under section 707(c).

The Recommendation is not intended to have any effect upon the tax treatment of any fringe benefit which is specifically dealt with by another provision of the Code, qualified plans, group term life insurance, health and accident plans, and legal services plans. In addition, any benefit which constitutes a transfer of property and which is not excludible under the Recommendation would remain subject to section 83.

The Recommendation relates only to the amount of income require to be recognized by the employee. Any deduction available to an employer would continue to be governed by existing provisions of the Code and regulations. Accordingly, the employer's deduction generally would equal the costs incurred in providing a fringe benefit.

As noted above, the Recommendation does not attempt to specify the tax treatment of particular fringe benefits. Although specific treatment of particular benefits might result in somewhat greater certainty with respect to those particular benefits, it is not possible to anticipate, and thus deal with, all of the possible items which might now or hereafter be provided as fringe benefits. Moreover, a fringe benefit might properly be taxable under some circumstances, but not others. Accordingly, the Recommendation is limited to a statement of general principles under which the tax consequences of the receipt of a fringe benefit are to be determined.

The proposed statutory language does not deal with the withholding questions which arise in connection with fringe benefits, but it is recommended that includible fringe benefits not be subject to withholding or other payroll tax requirements. However, the fair market value of any includible fringe benefits should be reportable as "other income" on Form W-2 or, with respect to nonemployees, on Form 1099 or Schedule K-1, as appropriate. Improper reporting or nonreporting should be subject to appropriate penalties (higher than existing law) either in the form of appropriate monetary penalties or, in aggravated cases, disallowance of deductions.

The general approach of the Recommendation is very similar to the proposals of the Joint Staff Task Force and the Federal Tax Division of the AICPA. However, the Recommendation differs from these two proposals in several important respects. The principal differences between the Recommendation and the Joint Staff proposal are that the Recommendation does not provide for an overall "insubstantial" limitation on excludible benefits. The principal difference between the Recommendation and the AICPA proposal is that the Recommendation would value all includible benefits at fair market value rather than the lower of cost or value as under the AICPA proposal. Further, the AICPA proposal defines benefits which are incident to the employer's business more narrowly than the Recommendation to include only facilities, goods and services which are produced, held for sale or furnished to the employer's customers. In addition, the AICPA proposal applies only to common-law employees and not independent contractors and partners. The Recommendation also differs from the two other proposals by providing a specific fifty dollar limitation in addition to the more subjective de minimis standard.

The Section of Taxation has no earlier recommendation that is related to this Recommendation.

No member of the originating committee or of the Council of the Section of Taxation is known to have a material interest in the Recommendation by virtue of a specific employment or engagement to obtain the result of the Recommendation. It is recommended that the amendment be given only prospective application. In that case, clients would not be affected in any pending matter.

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## PROPOSED STATUTORY LANGUAGE

*Resolved that the Section of Taxation implement the foregoing by urging the following amendments, or their equivalent in purpose and effect, on the proper committees of the Congress:*

Sec. 1. Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by redesignating section 128 as section 129 and by inserting after section 127 the following new section:

### SECTION 128. PERSONAL SERVICE BENEFITS

(a) In General.—Except as otherwise provided in this section, the excess of the fair market value of any personal service benefit over the amount (if any) paid for such benefit shall be included in the gross income of the individual who performed the services on account of which the benefit was made available.

(b) Benefits Incident to a Trade or Business.—Gross income does not include any amount attributable to a personal service benefit if—

(1) such personal service benefit is incident to the employer's trade or business.

(2) the marginal cost of providing all benefits of the same character as such personal service benefit to all recipients during the employer's taxable year is insubstantial in relation to the total cash compensation paid during such year by the employer to all individuals eligible to receive such personal benefits, and

(3) such personal service benefit is made available to a reasonable classification of individuals established by the employer which is not discriminatory in favor of officers, shareholders or other owners, or highly compensated individuals.

(c) Benefits Provided for the Benefit of the Employer.—Gross income does not include any amount attributable to that portion of any personal service benefit which is provided primarily for the benefit of the employer and where the benefits to the employee are incidental to the employer's business purpose (other than the purpose of paying compensation) in providing such benefits.

(d) Recreational, etc., Benefits for Employees.—Gross income does not include any amount attributable to a personal service benefit which consists of a recreational, social, or similar activity or facility, if the employer's deduction with respect to such activity or facility is not subject to the requirements of section 274(a) pursuant to the provisions of section 274(c)(5).

(e) Benefits of Nominal Value.—Gross income does not include any amount attributable to a personal service benefit if—

(1) the fair market value of such personal service benefit is not more than $50, or

(2) the fair market value of such personal service benefit is so small as to make accounting for it unreasonable or administratively impractical.

This subsection shall not apply if such personal service benefit is received on a frequently recurring basis during the taxable year.

(f) Definitions.—For purposes of this section—

(1) Personal service benefit.—The term "personal service benefit" means any transfer or use of property (other than cash or its equivalent) or services in connection with the performance of services by an individual, if such transfer is to, or such use is by, any person other than the employer.

(2) Employer.—The term "employer" means the person for whom personal services are performed; provided that the Secretary may prescribe by regulations the extent to which the term "employer" shall be limited to a particular business of the employing person or expanded to include persons related to the employing person within the meaning of section 482 or persons engaged in the same trade or business as the person for whom services are performed, or a related trade or business under an agreement or established practice. A partnership shall be treated as the employer of each of its partners.

(3) Marginal cost.—The term "marginal cost" means the incremental cost incurred by the employer in providing a personal service benefit, as determined under regulations prescribed by the Secretary. Such regulations shall provide for the computation of marginal cost by reference to variable costs, but without reference to any loss of revenue associated with the personal service benefit, and without reference to any of the employer's fixed costs except to the extent such fixed costs are included in the cost of an inventory item provided as a personal service benefit under the method of accounting used by the employer.

(4) Incident to a trade or business.—A personal service benefit is incident to the employer's trade or business if it consists of the transfer or use of property or services owned, controlled, or provided by the employer primarily for purposes necessary or appropriate to the conduct of its trade or business (other than the purpose of paying compensation).

(g) Applicability of Section.—

(1) This section shall not apply to any personal service benefit the tax treatment of which is expressly provided for in any other section of this chapter.

(2) Any personal service benefit which consists of a transfer of property that is not described in subsections (b), (c), (d) or (e) of this section, shall be governed by the provisions of section 83.

SEC. 2. The amendments made by section 1 shall be effective with respect to taxable years beginning after the date of enactment thereof.

## EXPLANATION OF PROPOSED STATUTORY LANGUAGE

Although not provided for in the proposed statute, it is contemplated that section 83 will not apply to a property transfer which is tax-exempt under the Recommendation. A conforming change will be needed to amend section 83(e) to indicate that section 83 does not apply to such fringe benefits.

Conforming and clerical amendments have not been made.

## APPENDIX B

## APPLICATION OF PRESENT LAW AND TAX SECTION LEGISLATIVE RECOMMENDATION TO THE TAXATION OF SPECIFIED FRINGE BENEFITS

### EXAMPLE (1)

A commercial airline makes transportation passes available to all of its employees. A nominal service charge is imposed for each pass. A pass entitles the employee, or any member of the employee's family, space-available transportation on any regularly scheduled flight of the airline. The number of passes avialable to an employee depends on his or her length of service. Upon completion of three years of service, an employee is entitled to an unlimited number of passes.

### PRESENT LAW

The value of these passes is potentially subject to taxation under section 61 of the Code. Administratively, the value of such passes is generally considered excludible from the employee's gross income under an extension of O.D. 946, 4 C.B. 110 (1921), the Treasury ruling dealing with railway passes.

### TAX SECTION RECOMMENDATION

The value of the transportation passes is excludible from the employee's gross income under subsection (b) of the Recommendation. The benefit is "incident" to the employer's business because it consists of the use of property owned or controlled by the employer primarily for purposes necessary or appropriate to the conduct of its business, other than the purpose of paying compensation. Since the employees travel only on regularly scheduled flights, on a space-available basis, the marginal costs of providing the personal service benefit is insubstantial. Finally, the personal service benefit is made available in a nondiscriminatory manner. The value of any passes made available to a family member is also excludible, because of the broad definition of "personal service benefit" in subsection (f)(1) of the Recommendation.

### EXAMPLE (2)

All of the employees of a law firm are entitled to free parking at a garage located near the law firm's downtown office. The law firm pays the garage a monthly fee based upon the number of employees who have parking privileges for the month. Each employee who wishes to take advantage of this benefit is issued a parking permit identical to that issued to other individuals who contract for parking on a monthly basis.

### PRESENT LAW

The fair market value of the parking privilege would be includible in the gross income of each employee to whom a parking permit is issued under section 61 of the Code.

### TAX SECTION RECOMMENDATION

The fair market value of the parking privilege is includible in the gross income of each employee to whom a parking permit is issued. The benefit is not incident to the employer's trade or business; nor does it qualify for exclusion under any other provision of the Recommendation. The fair market value of the parking rights is *determined by reference to the customary price charged by the garage to its monthly* contract customers.

### EXAMPLE (3)

An automobile manufacturer employs 10,000 individuals at an assembly plant located on the outskirts of a metropolitan area. Because sufficient public parking is unavailable, the automobile manufacturer constructed and maintains a large parking lot adjacent to its plant for the use of its employees. No charge is levied for such use.

### PRESENT LAW

The value of this free parking is potentially subject to taxation under section 61 of the Code, although an argument could be made under existing case law that the value of parking is not subject to tax because the parking is essentially a working condition which is provided primarily for the convenience of the employer. Furthermore, the value of this benefit might be viewed as de minimis. Historically, the Internal Revenue Service has not attempted to tax this specific benefit.

### TAX SECTION RECOMMENDATION

The value of the free parking provided to the employees is excludible under subsection (c) of the Recommendation. Under the facts and circumstances, the parking facility is provided primarily for the benefit of the employer. The absence of adequate public parking makes it necessary for the employer to provide parking in order to obtain the services of the needed number of employees.

### EXAMPLE (4)

A corporation maintains an airplane for the use ofd its executives on company business. The corporation also permits executives who are not engaged on company business to occupy a seat on a business flight if that seat would otherwise be unoccupied.

### PRESENT LAW

The fair market value of the flight of the hitchhiking employee is potentially subject to taxation under section 61 of the Code. This treatment is supported by the Joint Committee on Internal Revenue's report on the Examination of President Nixon's Tax Returns for 1969-1972, 93rd Cong., 2d Sess., at 157-168 (Washington: U.S. Government Printing Office, 1974). The value of the flights in the Nixon case was established with reference to the equivalent first-class airfare. The Internal Revenue Service has not been aggressive in seeking to tax flights made on a space-available basis.

### TAX SECTION RECOMMENDATION

The fair market value of the flight is includible in the gross income of an employee who hitches a ride on the corporate aircraft for nonbusiness reasons. The opportunity to use the aircraft for personal purposes is made available only to a classification which discriminates in favor of officers, shareholders, or highly compensated individuals, and thus the value of the benefit is not excludible under subsection (b) of the Recommendation. The fair market value of the flight must be determined on the basis of all the facts and circumstances.

### EXAMPLE (5)

An international corporation provides bodyguards to certain of its executives living or traveling in countries where terrorist acts are a realistic threat.

### PRESENT LAW

The fair market value of the bodyguards is potentially subject to taxation under section 61 of the Code, although a strong argument can be made under existing case law that the value of bodyguards is not subject to taxation because the bodyguards are essentially a working condition provided primarily for the benefit of the employer. The Internal Revenue Service has not attempted to tax this specific benefit.

### TAX SECTION RECOMMENDATION

An executive who is provided with a bodyguard is not required to include the value of such services in its gross income. The bodyguard is deemed to be provided primarily for the benefit of the employer, since the employer has an overriding business reason to maintain the safety of its key employees. Although the employee has an obvious and substantial interest in his own safety, the personal benefit derived from the bodyguard's services is incidential to the primary business purpose of the employer.

### EXAMPLE (6)

An oil company maintains an employees' country club. All employees of the corporation are entitled to use of the club's facilities upon payment of nominal monthly dues. A substantial majority of the employees who are members of the country club are not officers, shareholders, or highly compensated individuals.

### PRESENT LAW

The fair market value of the use of the country club's facilities is potentially subject to taxation under section 61 of the Code. Historically, the Internal Revenue Service has not attempted to tax these type of benefits.

### TAX SECTION RECOMMENDATION

An employee is not required to include the fair market value of the use of the country club's facilities in gross income. The employer's deduction with respect to the facility is not subject to the requirements of section 274(a) pursuant to the provisions of section 274(e)(5), and the benefit is thus excludible under subsection (b) of the Recommendation.

### EXAMPLE (7)

A corporation which owns and operates a hotel in a resort area provides rooms to travel agents at a substantial discount from the regular rate. The travel agents are not employees of the corporation which owns and operates the hotel.

### PRESENT LAW

The excess of the fair market value of the hotel room over the amount paid is potentially subject to taxation under section 61. Administratively, the Internal Revenue Service has not been aggressive in seeking to tax benefits of this nature.

### TAX SECTION RECOMMENDATION

The excess of the fair market value (i.e. the regular rate) of the hotel room over the amount paid by a travel agent is includible in the travel agent's gross income. Under subsection (f)(2) of the Recommendation, the hotel operator is not the employer of the travel agent. Accordingly, none of the exclusions set forth in the Recommendation apply. It should be noted, however, that the Service is authorized to prescribe regulations which would permit a person engaged in the same or a related trade or business as the person for whom services are performed to be treated as the employer of the person rendering services. Thus, the Service could issue regulations which would permit the hotel corporation to be treated as the employer of a travel agent, in which case the value of the benefit would be excludible under subsection (b) of the Recommendation if it were provided in a nondiscriminatory manner.

### EXAMPLE (8)

A retail clothing store permits all of its employees to purchase any merchandise held for sale to customers at a discount of 30% from the regular retail price. In some individual cases the discounted price is less than the wholesale price paid for the merchandise by the employer, but the average discount price exceeds the average wholesale price for all items of merchandise purchased by employees.

### PRESENT LAW

The value of the discount is potentially subject to taxation under section 61 of the Code. Administratively, the Internal Revenue Service has not attempted to tax such benefits.

### TAX SECTION RECOMMENDATION

None of the employees are required to include any amount in income as a result of the purchase of merchandise at a discount. The discount constitutes a personal service benefit which is incident to the employer's trade or business, and it is made available on a nondiscriminatory basis. Although the marginal cost of certain items of merchandise exceeds the discounted price paid for those items, the employer's marginal cost of providing all benefits of the same character to all recipients during the taxable year is zero.

### EXAMPLE (9)

An employer purchases season tickets for the home games of the local professional basketball team. The tickets are used for the purpose of entertaining customers and business associates, and the cost of the tickets is properly deductible under sections 162 and 274. Employees typically accompany the employer's business associates and customers at the games.

### PRESENT LAW

The value of the use of tickets ..y the employees is not considered to be includible in gross income, provided there is a proper business purpose (e.g. client entertainment) associated with the use.

### TAX SECTION RECOMMENDATION

The employees who attend the basketball games in connection with entertaining the employer's customers and business associates are not required to include the value of their tickets in gross income. The tickets are provided primarily for the benefit of the employer. Any personal pleasure derived by the employee from attending the basketball game is merely incidental to the employer's business purpose in furthering its relationship with its associates and customers.

### EXAMPLE (10)

An automobile dealer provides "demonstrator" automobiles for use by its salesmen. The salesmen are entitled to use the demonstrators for commuting and other personal purposes without any obligation to reimburse the employer with respect to such use.

### PRESENT LAW

The value of the personal use of the automobiles is subject to taxation under section 61 of the Code. See, e.g., *Dole v. Commissioner,* 351 F.2d 308 (1st Cir. 1965), aff'g per curiam 43 T.C. 697 (1965).

### TAX SECTION RECOMMENDATION

The fair market value of the personal use of the demonstrator automobiles is includible in the gross income of the salesmen under subsection (a) of the Recommendation. The benefit to the employee from using the automobile for commuting and other personal purposes is more than merely incidental to the employer's business purpose in making the car available. (The employer's business purpose is sometimes stated to be the advertising value derived from having the automobile on the road and thus in public view).

### EXAMPLE (11)

An employer provides Christmas gifts, such as bottles of inexpensive perfume, pen and pencil sets, etc., to its employees.

### PRESENT LAW

The value of de minimis Christmas gifts has been held to be excludible from gross income by Rev. Rul. 59-58, 1958-1 C.B. 17.

### TAX SECTION RECOMMENDATION

The value of the Christmas gifts is excludible from gross income under subsection (e) of the Recommendation. The fair market value of each gift is less than $50, and the benefit is not provided on a frequently recurring basis during the taxable year.

### EXAMPLE (12)

A law firm will prepare a will for any employee or partner who has completed one year of service. No charge is imposed for this service.

### PRESENT LAW

The value of this service is potentially subject to taxation under section 61 of the Code. Administratively, the Internal Revenue Service has not attempted to tax benefits of this nature in the past

### TAX SECTION RECOMMENDATION

No amount is required to be included in income with respect to the preparation of a will for an employee or partner of the law firm. The benefit is incident to the employer's trade or business, the marginal cost of providing the benefit is insubstantial in relation to the compensation paid to the individuals eligible to receive the benefit, and the benefit is made available in a nondiscriminatory manner. If the benefit were made available only to partners in the law firm, the value of the service would be includible in the gross income of a partner for whom a will was prepared, because the classification of individuals eligibile for the benefit would be discriminatory in favor of owners and highly compensated individuals.

### EXAMPLE 13

A university permits the children of members of its faculty to attend the university without charge. In addition, the children of the faculty members may attend certain other universities without charge under reciprocal agreements with such other universities.

### PRESENT LAW

Amounts paid under tuition remission programs are considered nontaxable scholarships under section 117 of the Code, by virture of Treas. Reg. § 1.117-3(a). In 1976, the Treasury attempted unsuccessfully to withdraw this regulation and tax amounts paid under tuition-remission plans. The Attempted withdrawal was revoked in early 1977.

### TAX SECTION RECOMMENDATION

A faculty member is not required to include any amount in gross income with respect to his child's tuition-free attendance at the university by which he is employed, provided that the limitation of the benefit to members of the faculty does not result in discrimination in favor of highly compensated individuals. Whether or not such discrimination results must be determined on the basis of all the facts and circumstances. If no such discrimination exists, the benefit is excludible under subsection (b) of the Recommendation, because the benefit is incident to the employer's trade or business and no substantial marginal cost is incurred by the employer in making the benefit available. (Of course, it is assumed that it is unnecessary to hire additional faculty members or to increase the size of the facilities to accommodate the children of faculty members.)

The value of the free tuition is includible in the faculty member's gross income if it is determined that the benefit is provided to a classification of employees which discriminates in favor of highly compensated individuals. In addition, a faculty member must include in gross income the value of this child's tuition-free attendance at another university, regardless of whether the benefit is provided in a discriminatory manner. The other university is not considered the faculty member's employer under the Recommendation, and thus none of the exclusionary provisions apply. As previously noted, however, the Service is granted the authority to broaden the definition of the term "employer", and thus bring tuition remission programs under reciprocal agreements within the ambit of the exclusionary rule set forth in subsection (b) of the Recommendation.

### EXAMPLE (14)

A company provides a chauffeur-driven automobile for transportation to and from work for each of its officers. The cars also are available to the officers during the day for trips to and from business appointments.

### PRESENT LAW

The fair market value of the transportation to and from work would be includible in the gross income of each officer to whom the automobile is furnished. That portion of the use allocable to transportation to and from business appointments would not be subject to taxation.

### TAX SECTION RECOMMENDATION

The fair market value of the transportation to and from work is includible in gross income. The opportunity to use the limousines is made available only to a classification which discriminates in favor of officers, and thus the value of the benefit is not excludible under subsection (b) of the Recommendation. Further, the cost of furnishing these automobiles and drivers undoubtedly would be considered substantial. The value of that portion of the use allocable to transportation to and from business appointments would be considered as being provided primarily for the benefit of the employer and not taxable under subsection (c) of the Recommendation.

### EXAMPLE (15)

A large company with its corporate headquarters adjacent to its plant in an industrialized area of a large city maintains a dining room for its executives in order to permit them to conduct business luncheons among themselves and outside persons with whom the corporation transacts business. The dining room is open to all executives above a certain level which includes some non-officers. The executives are required to pay for their own meals and the price of the meals are established to recover the full costs of operating the dining room facility.

### PRESENT LAW

The excess of fair market value over the cost of the meals is potentially subject to taxation under section 61 of the Code. The Internal Revenue Service has not been aggressive in seeking to tax this benefit, presumably because of the administrative burdens and the existence of the argument that it serves the business needs of the employer to have its executives take their meals in this facility.

### TAX SECTION RECOMMENDATION

The dining facility arguably is necesary and appropriate to the employer's business and, thus, incident to its trade or business. The meals are furnished at no additional cost to the employer and are made available on a nondiscriminatory basis to a reasonable class of employees which includes some non-officers. Thus, the bargain portion of the meals should be excludible from gross income under subsection (b) of the Recommendation.

### EXAMPLE (16)

A manufacturing company maintains a cafeteria which is open to all employees and which serves meals at prices established to cover the full cost of operating the cafeteria. The company's plant is located adjacent to the downtown area of a large facility where adequate eating facilities are available.

### PRESENT LAW

The excess of the fair market value over the cost of the meals is potentially subject to taxation under section 61 of the Code. The Internal Revenue Service has not been aggressive in seeking to tax this benefit, presumably because of the administrative burdens.

### TAX SECTION RECOMMENDATION

The cafeteria would not be considered to be incident to the employer's business because of the existence of nearby alternate eating facilities. Thus, the benefit would not be excludible under subsection (a). The benefit might be considered de minimis and excludible under subsection (e) on the ground that it is so small as to make accounting for it unreasonable and administratively impractical except for the fact that the benefit would presumably be received by employees on a frequently recurring basis.

Chairman STARK. Mr. Walker.

## STATEMENT OF MICHAEL WALKER, MEMBER, EXECUTIVE COMMITTEE OF THE FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. WALKER. Thank you, Mr. Chairman.

I am Michael Walker from Albuquerque, N. Mex. I am a member of the Executive Committee of the Tax Division of the American Institute of CPA's.

The American institute generally supports the overall concept of H.R. 3525 as it is written. The institute, as a matter of fact, has long had a published opinion dating back to 1979 favoring the passage of legislation and believe the events of the last 8 years have certainly demonstrated the need for such legislation based upon the Treasury's failure to adopt regulations which are acceptable and workable as well as the inconsistent application by the Internal Revenue Service and in the courts.

As for the characteristics of the legislation, we believe generally that it should codify most of the existing practices that are prevalent today, particularly in the mass benefit area. With certain modifications, and as I indicated previously, the AICPA would support the legislation as a workble solution to the problem.

A few specific areas I would propose for your consideration are as follows:

First, in the area of qualified employee discounts, we believe that the 20 percent limitation should be dropped for the following reasons:

One, in many instances it will create not only an onerous but administratively unworkable bookkeeping requirement on the employers as well as the Service to audit it.

Second, in many industries it is common to have sales to the general public, that is to say markdowns, which greatly exceed 20 percent. So we believe that the free functioning of the marketplace as it has in the past will operate to control this particular fringe benefit.

In the area of auto demonstration, if this is to be part of the statute, we believe that the section as written is a little too restrictive in that there are various other employees of auto dealers who also have demonstration automobiles which are provided to them upon the same terms as the salesmen. So we believe that the provision should apply to all bona fide employees of auto dealers who are provided such demonstrator autos.

With respect to on-premises recreation facilities, we believe that existing facilities should be treated with a special rule which would not come within the ambit of the new proposed legislation if only to provide depreciation on them for the duration of their existence. We believe they should be grandfathered in and treated differently from those facilities which may be constructed after the passage of the bill.

In terms of the definition the bill provides we feel that the bill should be restricted to cover only the employer-employee relationship. Until such time as Congress acts and passes definitive legislation, in the area of independent contractors, we believe that the fringe benefit legislation should not also cover that area. Once that definition is clear and that class defined, then appropriate legislation can be enacted to cover the independent contract area.

Finally, Mr. Chairman, we believe that either the bill or the technical explanation accompanying should be quite clear that the legislation will cover all sectors of the economy, that is to say, military, governmental, not-for-profit, et cetera.

We thank you for the opportunity to appear here before you today and of course we will be happy to answer any questions you may have.

Chairman STARK. Thank you very much, Mr. Walker.

[The prepared statement follows:]

## STATEMENT OF MICHAEL WALKER ON BEHALF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

My name is Michael Walker from Albuquerque, New Mexico. I am a member of the Executive Committee of the Federal Tax Division of the American Institute of Certified Public Accountants. We appreciate the opportunity to appear before you today to present the position of the AICPA on H.R. 3525.

### GENERAL COMMENTS

The passage of specific legislation pertaining to the taxation of fringe benefits is the only permanent and workable solution to this ongoing problem. During the past eight years, the Treasury Department has issued two drafts of proposed regulations in an attempt to provide guidance and clarity to employers, employees, the Internal Revenue Service, and tax practitioners. Although these attempts were certainly commendable, their lack of general acceptance has demonstrated the futility of the approach.

The Internal Revenue Service has expressed contrary views to those of the Treasury from time to time on fringe benefit taxation. Those taxpayers affected express concern over the relative ease in which today's nontaxable benefit can become tommorow's revenue source. Further, it appears that the Treasury may not have the authority to promulgate such regulations in contravention of Code section 61, which taxes all sources of income not otherwise specifically excluded.

### REQUIRED CHARACTERISTICS OF FRINGE BENEFIT LEGISLATION

As a general matter, and at a minimum, legislation affecting fringe benefits should be:

(1) Durable: it should withstand the passage of time and not require constant tinkering as employers invent new fringes in an attempt to provide non-taxable compensation.

(2) Uniform: it should recognize that similar classes of taxpayers should be taxed in the same manner, and that the Internal Revenue Service and the Courts require guidelines for consistent application.

(3) Acceptable: it should be acceptable to the largest possible body of taxpayers to protect the integrity of the self-assessment system.

One further point, the legislation should codify long standing practices of excluding certain currently non-taxed benefits, especially in the so-called "mass benefits" area. To do otherwise would promote instant unacceptability, disregard and distaste of the taxing system, as well as some upheaval and unrest in certain segments of the economy.

In a more specific view, the AICPA believes that fringe benefit legislation should exclude from taxation only those mass benefit perquisites which are:

(1) Provided on a nondiscriminatory basis;

(2) Provided at no substantial additional cost to the employer; and

(3) Provided in the normal course of the employer's business.

Other fringe benefits should also be excluded from taxation if they are job related or provided as an incident to the employer's working conditions. Finally, administrative feasibility should be observed with the inclusion of a de minimis provision to exclude insignificant benefits.

We believe that H.R. 3525, with certain modifications, generally meets these requirements.

### SPECIFIC SUBSTANTIVE COMMENTS

*(1) Qualified employee discounts*

The employee discount should not be limited to any specific percentage of normal retail price. This provision may cause more problems than it solves, by imposing additional as well as onerous record keeping requirements on employers relating to the computation of gross profit percentages. Further, in many industries, it is quite common for employers to offer their products to the general public at sale prices well below a 20 percent markdown. We believe that the proper test for an employee discount should provide that the item offered is one generally provided in the employer's normal business at no substantially additional cost.

*(2) No-additional-cost service*

This section should be enacted as proposed, since it is restricted to only those services provided by the employer only to its own employees.

*(3) Auto demonstration*

The restriction of the exclusion to "automobile salesmen" should be broadened slightly to also cover other automobile dealer employees whose demonstrator autos are subject to the same restrictions as the salesmen's. It is the normal practice of the industry to provide autos to certain other employees on the same basis as those provided salesmen. Thus, parity in taxation should be provided.

*(4) On-premises recreational facilities*

To avoid harshness and a complete reversal of present practice, the operating costs of those facilites already in operation should be excluded from the ambit of proposed section 280F. At a minimum, taxpayers should be entitled to recover through depreciation their fixed investment in such facilities.

### ADDITIONAL RECOMMENDATIONS

*(1) Independent contractors*

The AICPA believes H.R. 3525 properly excludes independent contractors and other non-employees from its coverage. The employer-employee relationship is legally and practicably distinguishable from contractor relationships. Until Congress has resolved this problem overall, fringe benefit legislation should not encompass non-employees.

*(2) Related corporate employers*

The legislation should provide that an individual will be considered to be the employee of the employer for which he actually performs services, rather than the employer which provides the compensation. This will restrict the provision of the benefits to the intended class of employees, and recognize the existence of the "common paymaster plan," whereby one employer may pay an employee who works for several employees.

*(3) Scope of employee class*

To ensure overall equity among taxpayers and enhance acceptability, all classes of employees should be brought under the proposed Act. Thus, either in the Act itself, or in the technical explanation, reference should be made to the military and governmental sectors.

We appreciate the opportunity to participate in these hearings. The AICPA has been in the forefront of advocating legislation, and has worked with the Joint Committee Staff and Treasury to this end for many years. We offer our continued assistance in a mutual effort to resolve this problem. I'd be happy to respond to any questions you may have.

Chairman STARK. I would note for the record at this point that Mr. Odmark, who is from my home State of California, has provided this subcommittee useful information in the past, and I am sure will do so today. Mr. Odmark.

## STATEMENT OF ROBERT C. ODMARK, TAX PARTNER, PRICE WATERHOUSE, SAN JOSE, CALIF.

Mr. ODMARK. Mr. Chairman, I am Robert Odmark, a Price Waterhouse tax partner based in San Jose, Calif.

I am happy to be before you today to discuss H.R. 3525 which would provide permanent rules for the tax treatment of fringe benefits.

We are pleased that a serious attempt has been made to have legislation to make a congressionally imposed moratorium no longer necessary. We believe that the lack of clear rules has created a public uncertainty of tax abuse and undermines our voluntary tax system. We have several possible modifications that I want to discuss with you which we believe will be helpful in a fair application of the law without changing your overall intent.

First, with respect to related corporations, the technical explanation makes it clear that when one corporation is in more than one business, employees can receive tax-free benefits only from the business in which they work. But another common situation is to have several corporations that are related engaged in the same trade or business and we think that a provision should be made that employees of any related corporation who work in the same business also are able to receive the fringe benefits.

Second, we believe that there should be parity between self-employed and common law employees who work in the same business. This is particularly common in small businesses where the proprietor has several employees working for him and that all the people who work in that same business should be able to receive the same tax-free fringe benefits.

With respect to employee recreational facilities, proposed section 280 of H.R. 3525 bars employer deductions including depreciation in connection with employee recreational facilities. Many corporations constructed facilities with the expectation that the cost of the facility could be depreciated as a legitimate business expense. We believe an inequity will result to the extent depreciation is not allowed on facilities which were built or committed to be built when the legislation is enacted.

We believe that deductions for depreciation of such facilities should be allowed where a business decides to continue the operation of the facility. If it is decided to discontinue the facility because of the new legislation an abandonment loss, should be allowed for any unrecovered cost to the extent the facility cannot be used for other purposes.

With respect to qualified employee discount computations, Mr. Chairman, the current bill allows employee discounts equal to the lesser of 20 percent of the price at which the property or services are offered to nonemployee customers or the actual employer's profit percentage.

The two tests highlight an inequity between the treatment of discounts to service industry employees and discounts to employees of retailers and manufacturers. We see no reason for having the 20-percent test.

The gross profit test would put all employees on an equal footing and still prevent employers from offering a discount which is greater than their gross margin.

A further explanation is also needed regarding the computation of the gross profit for a manufacturing business. We believe that the cost for purposes of this computation should not include fixed cost. We don't believe it reasonable to compute costs based on full absorption costing. The employer's profit percentage varies widely based on whether the employers recover fixed costs, particularly where two employers in the same business, one has brand new plant and the other has fully depreciated plant. Benefits between employers in the same industry would be more equitable using variable costs because variable costs tend to be more comparable between employers than costs which fully absorb fixed overhead.

The last point is there is a provision regarding cafeteria plans. H.R. 3525 would limit the benefits offered under cafeteria plans to cash and certain statutory fringe benefits. There are a number of modifications which are currently being considered regarding cafeteria plans and we believe that this one provision put into this bill should be pulled out and should be dealt with along with all of the modifications which are being considered.

We believe further study is necessary and changes should be dealt with in separate legislation.

That concludes my prepared testimony. I will be happy to answer any questions the subcommittee may have for me.

Chairman **STARK**. Thank you very much, Mr. Odmark.

[The prepared statement follows:]

## STATEMENT OF ROBERT C. ODMARK, TAX PARTNER, PRICE WATERHOUSE

### SUMMARY

Price Waterhouse supports the goal of codifying the Federal income tax treatment of fringe benefits. In general, we believe H.R. 3525, introduced by Representatives Stark and Conable, contains fair and workable guidelines. We also believe the following modifications should be made to the legislation:

Congress should treat employees of related corporations as employees of a single employer in determining which fringe benefits may be provided.

There should be parity in the tax treatment of self-employed individuals and common law employees.

A transitional provision which would allow taxpayers to continue depreciation deductions on investment made or committed to recreation facilities at the date of enactment should be included in the legislation.

The 20-percent limit on discounts should be eliminated, leaving as the only test the employer's actual profit margin. This would eliminate any inequities in the treatment of discounts to service industry employees relative to discounts to employees of retailers and manufacturers.

Including fixed overhead in costs in the measurement of "profit percentage" creates unwarranted and probably unintended disparities in the tax treatment of fringe benefits in various industries.

Cafeteria plan legislation should not be enacted on a piece-meal basis. Any changes in cafeteria plan rules should come as part of a comprehensive re-examination of cafeteria plans.

### STATEMENT

Mr. Chairman, I am Robert C. Odmark, a Price Waterhouse tax partner based in San Jose, California. In late 1977, when the American Institute of Certified Public Accountants' Federal Taxation Division formed a task force to study the taxation of fringe benefits, I was chosen to serve on it. I am happy to appear before you today as a representative of my firm to present comments on H.R. 3525, which would provide permanent rules for the tax treatment of fringe benefits.

Congressionally imposed moratoriums have prevented the Internal Revenue Service from issuing guidelines in the fringe benefits area. Widespread uncertainty exists regarding the taxability of many benefits. This uncertainty creates a public perception of tax abuse and undermines our voluntary tax system.

We at Price Waterhouse are pleased that a serious attempt has been made to resolve the stalemate and provide reasonable rules which can be administered without undue hardship. We have outlined below several possible modifications to the legislation which we believe would be helpful in fair application of the law without changing the overall intent.

*Related corporations*

The technical explanation of H.R. 3525 makes it clear that when a corporation has more than one trade or business an employee may receive a benefit only from the trade or business in which he or she is employed.

The nondiscrimination rules for existing statutory fringe benefits, such as pensions, apply to a controlled group of corporations or other related businesses. We believe that the same standards should apply to the fringe benefits addressed in this bill. In our view, both the nondiscrimination rules in H.R. 3525 and the ability to exclude certain benefits from income should be determined by looking at related business entities.

*Parity between self-employed and common law employees*

Self-employed individuals working in a trade or business often receive fringe benefits identical to employees of the business. This is particularly true of "working condition" fringes and "de minimus" fringes. Examples would include office furnishings and supplies, secretarial services, parking, coffee, etc.

H.R. 3525 does not specify whether the term "employee" includes self-employed individuals. Congress should clarify the bill to extend the same fringe benefits treatment to self-employed individuals. Such a clarification is needed to prevent inequitable treatment and administrative burdens on small business.

*Employee recreational facilities*

Proposed Section 280F of H.R. 3525 bars employer deductions, including depreciation, in connection with employee recreational facilities. Many corporations have constructed these facilities with the expectation that the cost of the facility could be depreciated as a legitimate business expense.

We believe an inequity will result to the extent depreciation is not allowed on facilities which were built or committed to be constructed when the legislation is enacted. We believe that deductions for depreciation of such facilities should be allowed where a business decides to continue the operation of the facility. If it is decided to discontinue the facility because of the new legislation, an abandonment loss should be allowed for any unrecovered costs to the extent the facility cannot be used for other purposes.

*Qualified employee discount computation*

H.R. 3525 would allow employers to offer employee discounts equal to the lesser of (1) 20 percent of the price at which the property or services are offered to nonemployee customers or (2) the employer's actual profit percentage. We see no problem with the example in the technical explanation of H.R. 3525 (which is based on a retail department store) in the mechanics of the computation of the employee discount.

The two tests highlight, however, an inequity between the treatment of discounts to service industry employees and discounts to employees of retailers and manufacturers. We see no reason for having the first test. The second test would put all employees on an equal footing and still prevent employers from offering a discount which is greater than gross margin.

A further clarification is needed regarding the computation of the profit percentage for a manufacturing business. We believe that "cost" for purposes of this computation should not include fixed costs. Thus, using the example provided in the technical explanation of the bill, if the marginal cost to an employer of producing another appliance was $85 and the price at which it would be sold would be $100, the maximum discount would be $15.

We do not believe that it is reasonable to compute cost based upon full absorption costs. An employer's profit percentage varies widely based on whether the employer is recovering his fixed costs, such as plant depreciation. Benefits between employers in the same industry would be more equitable using variable costs because variable costs tend to be more comparable between employers than costs which fully absorb fixed overhead.

*Cafeteria plans*

H.R. 3525 would limit the benefits offered under cafeteria plans to cash and certain statutory fringe benefits.

Cafeteria plans are an important new type of employee benefit under which employees can choose between taxable and nontaxable benefits without adverse tax consequences. For example, an employee can elect to receive less costly medical coverage plus cash. Many employers believe cafeteria plans can be extremely helpful in containing health care costs and in providing benefits programs that reflect the changing composition of today's workforce.

We recognize that under certain circumstances cafeteria plans could be subject to abuse, and H.R. 3525 attempts to prevent such abuse. Legislative changes in this area require extensive deliberation, however. We believe that further study is necessary and changes should be dealt with in separate legislation.

That concludes my prepared testimony. I will be happy to answer any questions the Subcommittee may have of me.

Chairman **STARK**. Mr. Padwe.

## STATEMENT OF GERALD W. PADWE, NATIONAL DIRECTOR, TAX PRACTICE, TOUCHE ROSS & CO., ACCOMPANIED BY RICHARD JOHNSON, EMPLOYEE BENEFITS SPECIALIST

Mr. **PADWE**. I am the national director of tax practice for Touche Ross & Co.

I am accompanied today, somewhere in this vast throng, by Richard Johnson, an employee benefits specialist in our Washington service center tax department.

We are here to support the thrust of H.R. 3525. Our general conclusion is that this bill is an excellent first step and probably second and third step as well. It is carefully thought out and well put together.

I think the four-pronged approach you have in there——

Chairman **STARK**. Don't rush, Mr. Padwe. You can have all the time you want.

Mr. **PADWE**. We think the four-pronged approach you have in the bill sets a good framework for consideration of the issues involved here. We think the bill does have problems although it does seem to be responsive to a number of the practices that have come into being. Therefore, our bottom line is that we would urge this Congress to bite the bullet and try and get a fringe benefits bill enacted this year, and we support your call to that effect, Mr. Chairman.

Don't just extend the moratorium for another 2 years or 3 years. There is no moratorium on court action and how many times can you just extend the status quo of do nothing before trying to do something else?

We feel a better answer is to use H.R. 3525 as a starting point and go forward to try to get a new bill this year.

Just a fast note on history: we have attached to our statement a series of charts which take a look at the 1975 Treasury discussion draft, the 1981 Treasury draft, the AICPA recommendations of 1979, the ABA 1980 recommendations, and compared to them our analysis of H.R. 3525.

We would ask you to recognize that the conclusions we came to in those charts are strictly our own. There is certainly room for disagreement, and for the H.R. 3525 column we show what we think would be the results under the bill as introduced by you and Mr. Conable, as opposed to what we think the answer ought to be.

The interesting conclusion from that analysis, though, seems to be that there is a good deal of commonality in the results from the various approaches, and this adds to our view that the bill is a good springboard for action as well as for discussion.

There are a number of areas we have addressed in our written statement where we feel the bill needs improvement. With the time limitation, I would like to concentrate on one of them, possibly a second if time permits. That one has to do with the 20-percent limitation on the one hand for employee discounts, versus the full tax-free nature of no—additional—cost services.

We see this division as very discriminatory against employees of retail establishments—department stores would be a good example—and we think it produces anomalous results that need not be. Take the example of a husband and wife: she is a flight attendant who, under this bill, could fly free from Washington to Hong Kong and back with no taxable income to her whatever; her husband, on the other hand, an executive in a Washington department store, could buy a pair of $30 trousers in his store for $20, but because this violates the 20-percent discount limitation he would have to pick up a few dollars in income as a result of that purchase.

We feel that this doesn't really make a great deal of sense, and we further believe the problem can be addressed in a somewhat better way. My colleague from the AICPA has suggested just dropping altogether the 20-percent limitation. If you wanted, on the other hand, to just put the employee discount on the same theoretical basis as the no-additional-cost service, you could raise that limitation to the employer's gross profit margin, whatever that might happen to be.

On that basis, the employer will not incur any substantial additional cost to provide the trousers to the employee's husband, just as the airline incurs no substantial additional cost providing the seat for the wife. And, you will not be tied to a very rigid 20-percent discount in these circumstances.

The red light is on, so I will stop, but I cannot leave employee discounts without one point, Mr. Chairman. We feel that the bill offers, with tongue only slightly in cheek, at least one opportunity for a new fringe benefit that could be very helpful for governmental recruiting. Consider the possibility that this bill is so well drafted it might apply to agents of the Internal Revenue Service to permit them a 20-percent discount on tax liabilities from examination of their own income tax returns. Unfortunately, I must tell you it would not apply to Members of Congress, because they are not in the trade or business of examining tax returns. Nonetheless, there are real opportunities here. We applaud you and Mr. Conable.

Thank you.

[The prepared statement follows:]

## STATEMENT OF GERALD W. PADWE, NATIONAL DIRECTOR—TAX PRACTICE, TOUCHE ROSS & CO.

Mr. Chairman and members of this distinguished subcommittee, my name is Gerald W. Padwe, and I am the National Director of Tax Practice for Touche Ross & Co., an international tax consulting and accounting firm. I am accompanied today by Mr. Richard L. Johnson, an employee benefits specialist in our Washington Service Center tax department. I appreciate the opportunity to present this morning our views on H.R. 3525, relating to the tax treatment of fringe benefits. As tax practitioners, we are familiar with many of the problems and frustrations caused both by the increasing importance of nonstatutory fringe benefits in overall compensation plans and th present statutory moratorium on Treasury or Internal Revenue Service guidelines to the public or specific taxpayers.

Consequently, we have been concerned with the tendency to extend the moratorium on fringe benefit rules and regulations, and the apparent unwillingness of Congress to seek a statutory framework within which to address the overall problem of fringe benefit taxation. Failure to enact such a framework, coupled with inability of IRS and Treasury to act, means that fringe benefit issues, are, essentially, decided by the courts on an ad hoc basis. Should the moratorium on regulations and rulings continue to be extended indefinitely, and should Congress fail to enact comprehensive legislation, we are faced with the taxation of all fringe benefits becoming potentially a subject of judicial determination on a case-by-case basis. The results of such judicial determinations are, of course, unpredictable. In addition, continued inaction discourages voluntary compliance and effective administration of the tax laws. Thus, we are pleased—in general—with the introduction of H.R. 3525. It is a well-thought-out bill. From our perspective, it has its own problems and flaws—and we certainly do not agree with every part of its language—but a good deal of work seems to have gone into addressing the important issues of nonstatutory fringe benefit taxation, to the point that H.R. 3525 could serve as a basis for finally resolving many of the still unanswered questions. It is, at the least, a vital first step.

Accordingly, we would urge this Congress not to take the easy way out and merely extend the moratorium for another two years or so. We feel you have gone far enough, in this bill, that finishing the task should be worth the struggle.

Having urged you to further action, let me quickly point out that we believe the bill still needs improvement. Our thoughts for your consideration on that subject follow shortly. Before turning to them, however, let me indicate why our general reaction to the bill introduced by Representatives Stark and Conable is optimistic, and why we feel it could be an essential building block on which to resolve most of the issues of fringe benefit taxation.

The bill under discussion today is, of course, not the first comprehensive fringe benefit proposal. The Treasury Department in 1975 issued a discussion draft on this subject, in the form of non-proposed Proposed Regulations. The American Institute of CPAs and the American Bar Association Section on Taxation had groups examine the subject of fringe benefit taxation and make recommendations as to the concepts and policies that should be the basis for a new framework, the AICPA in 1979 and the ABA Tax Section in 1980. Treasury came back in January, 1981, with another set of proposals for consideration, which varied some from the 1975 discussion draft.

We have taken most of the specific fringe benefits described in those sets of proposals, tested them against the criteria for taxation in each of the proposals, and added our views as to how they would be taxed should H.R. 3525 be enacted in its proposed form. That chart is attached behind this statement. What we find interesting about the chart is while the outcome is not the same in every case, there seems to be a very common thread among the earlier proposals and how they would track under H.R. 3525. Thus, utilizing what we perceive as a fairly pragmatic approach, we do not find irreconcilable discrepancies between the results reached in H.R. 3525 and those recommended over a period of years by two separate Treasury Departments (one Republican, one Democrat) and representatives of the two professions most closely involved with tax practice.

Let us, then, turn to some of the areas in which we feel the bill should be strengthened or changed.

### DEFINITION OF "EMPLOYER"

With regard to the exclusions for "no-additional-cost services" and qualified employee discounts, we believe it critical that any legislation include a definition of "employer". To this end, we recommend the committee consider applying the rules under existing Code sections 414(b) and (c). In general, these rules provide that where employers are members of a commonly controlled group, the employees of one member employer are also considered employees of any other member employer. In light of the "same trade or business" limitation applicable with respect to both exclusions, ignoring the formalities of corporate organization is not inconsistent with the apparent intent underlying the exclusions. Defining "employer" by reference to sections 414(b) and (c) would, for example, allow an employee of XYZ Store No. 1 a qualified employee discount at XYZ Store No. 2, although each XYZ Store is a separate corporate subsidiary, and therefore otherwise a separate "employer". It would also allow, as we believe it should, a retailer made up of separately named subsidiaries to offer an employee of any one subsidiary retailer an excludable employee discount for purchases made in any other subsidiary retailer.

We believe the committee should also address the status of holding company employees under the "same trade or business" limitation. Where the operations of the separate subsidiary corporations of the holding company involve the same trade or business, holding company employees should be treated as performing services in such trade or business. Where the operations of the separate subsidiary corporations involve different trades or businesses, the status of a holding company employee is unclear. Should such employee be treated as performing services in all such trades or business, or, perhaps, none of the trades or businesses?

### FULL EXCLUSION FOR "NO ADDITIONAL COST" SERVICES VERSUS 20 PERCENT EXCLUSION FOR EMPLOYEE DISCOUNTS

One area of serious concern to us is what appears to be unwarranted discrimination against employees who purchase goods at a discount vis a vis those who receive benefits in the form of services. In the first case, there is a 20 percent maximum limit on the amount of discount which can be obtained without incidence of taxation; in the second, there is no limit on the "discount" for services provided, so long as there is no substantial additional cost to the employer.

Thus, for example, the bill could face us with the anomalous situation where a flight attendant could fly free, round trip, between Washington and Hong Kong, and have no amount included in income. Her husband, on the other hand, who is an executive in a Washington department store, could buy a pair of $30 trousers for $20, and have to pick up part of the discount in income because it violates the 20 percent limit.

This, to us, makes no sense; and we would urge, strongly, that the bill be changed to make the treatment of employee discounts more equitable. It should be possible to put providers of goods on an approximately equal footing with providers of services in terms of no additional cost by raising the limitation on employee discounts to the employer's gross profit percentage. It is true that an airline employee would still be entitled to a free trip aboard the employer's plane while a retail clerk would not be entitled to free merchandise. On the other hand, in both cases the employee is entitled to an excludable fringe benefit to the extent the employer incurs no substantial additional cost in providing it.

Eliminating the 20 percent limit for qualified employee discounts may also greatly simplify the rules for wholesalers and manufacturers. Such employers are likely to sell to customers only in bulk, but to their employees in single units. Prices to customers will probably vary depending on the quality purchased. Thus, any price established for purposes of the 20 percent limit on sales to employees could be, at best, an approximation. Permitting income exclusion under section 132, if the price charged the employee is no less than employer's cost, is a more realistic approach, and should avoid the inevitable question, "20 percent of what?"

### DISCOUNTS OFFERED BY THIRD PARTIES

We recommend it be made clear that where a purchase discount is offered an employee by a person other than the employer, the discount is an employee fringe benefit subject to the bill's provisions only if (1) it is offered pursuant to a reciprocal or similar agreement with the employer, or (2) the employer and the person offering the discount are related through common ownership. For example, it may not be uncommon for a manufacturer of finished products to offer purchase discounts to employees of an unrelated parts supplier. Such a discount is more appropriately characterized a marketing technique of the manufacturer than an employee fringe benefit offered by the parts supplier. Clarification is similarly required with respect to "no-additional-cost services" provided an employee by a person other than the employer.

### CASH REBATES FROM EMPLOYER

We recommend that any legislation relating to employee discounts specifically address the treatment of cash rebates. In some cases, a manufacturer may offer employees a rebate upon their showing proof of purchase of the employer's goods. The rebate is offered in lieu of a direct sale by the employer at a discounted price. The employee rebate is the substantial equivalent of the employee discount, and should be eligible for the income exclusion. In addition, if an employee rebate is offered by a manufacturer or wholesaler, the discount percentage limitation should be determined by reference to the wholesale price rather than the retail price at which the purchase was actually made.

### LEASED DEPARTMENTS

We are concerned that the provision relating to leased areas of department stores, in referring to "over-the-counter sales", may be construed to preclude application of the leased area rule where the lessee offers services rather than goods. Subject, of course, to the over-riding "same trade or business" limitation, we believe that the leased area rule should apply without regard to whether the lessee offers goods or services.

### DISCRIMINATION

Under the bill, certain of the exclusions are to apply only if the fringe benefit is made available to employees on a non-discriminatory basis. We agree that the non-discrimination requirement, is appropriate. However, as we read the bill's language, it would appear that all employees would be taxed on the benefit if the anti-discrimination rules are violated. We question why every employee should be denied an exclusion merely because the employer provides a more valuable benefit to a select group of employees—those who are officers, owners, or highly compensated. Accordingly, we recommend that any non-discrimination requirement be applied to deny an exclusion only to the extent a fringe benefit subject to the requirement is made available on a discriminatory basis.

The rule should similarly apply with regard to "no-additional-cost service" and employer-provided parking. Thus, only those employees in favor of whom discrimination is prohibited would be required to include the value of employer-provided parking in income.

### VALUATION

Perhaps the valuation issue, as much as any other, has prevented the adoption of a uniform approach to taxation of non-statutory fringe benefits. In our judgment, the Stark-Conable bill is deficient in addressing some aspects of the valuation problem.

At the outset, we note that proposed section 132 takes no position, per se, on the determination of income inclusion where a fringe benefit fails the section 132 test. The technical explanation does state that a non-excludable fringe benefit will be taxable under Code sections 61 and 83, based upon fair market value. However, there is apparently no proposal to amend section 83 so that it will apply, specifically, to goods or services failing the exclusionary rule of section 132. And, since section 83 presently applies only to the transfer of "property," it is not clear whether a fringe benefit provided in goods should fall within the purview of that section while one provided in services (and, presumably, therefore not a property interest) would fall under the catch-all provision of section 61. In the section 83 instance, regulations (with which, by the way, we do not agree) deny completely a deduction to the employer for failure to withhold. No similar provision is present for income included only by virtue of section 61. Thus, there would seem to be a need to harmonize the tax treatment of benefits falling outside the exclusionary rules, depending upon whether they are provided in goods or services.

We do not intend to get into the impossible-to-win debate as to whether fair market value or some measure of cost (allocable or incremental) is the proper measure of income inclusion. The 1980 ABA recommendation was for fair market value, the AICPA recommended—in general—incremental cost. We recognize that each has its theoretical advantages and each raises significant problems. Since the general rule of income inclusion, in our tax system, is fair market value, we do not quarrel with the bill's implicit use of that measure—though we believe the standard should be made explicit, either in section 132 or 83.

But, we would ask Congress to provide some guidelines as to how fair market value should be determined. Granted, this is not an area which would normally be considered appropriate for statutory, as opposed to regulatory, consideration. We believe, however, that the problem of valuation, particularly in the context of services, can lead to some results that make the accounting and recordkeeping almost impossible for employers, and we would ask that Congress direct Treasury to provide valuation regulations that will give strong weight to administerability, not only by the IRS, but also by an employer.

A case in point: assume a corporate airplane, which would otherwise have an empty seat, takes along the wife of the one of executives going on what is, to him, a business trip. What is the fair market value of the seat she occupies? Is it the cost of a first-class commercial ticket between the two points? Is it, instead, the cost of chartering a plane between the two points? (Even the courts do not necessarily agree on the answer to this question.) In this particular situation, we would argue for the former, on the grounds that for the relatively small number of additional dollars involved, it does not make sense to require the employer to determine what various charter companies might charge for such a trip, and then have to retain some kind of records on the telephone calls to substantiate the basis for income inclusion and tax withholding.

Another valuation/recordkeeping problem arises with respect to benefits provided by third parties. For example, under the bill, a "no-additional-cost fringe" is nevertheless included in an employee's income where it is provided by a person other than the employer pursuant to a reciprocal agreement. It is unclear how, or whether, the person providing such a taxable fringe benefit is to account for it. If it is intended that the service provider report the taxable benefit to the individual's employer, such a requirement, together with an appropriate enforcement mechanism, should be included in any legislation. In such a case, it is also unclear who should bear the responsibility for valuing the taxable benefit, the service provider or the employer.

Despite the reservations discussed above, we still believe H.R. 3525 is an excellent basis on which to fashion what we consider to be the necessary framework for the tax treatment of a broad range of fringe benefits. Clearly, many will find the bill disappointing, in one or more parts, because it does tighten up on what the rules have been. Still, as we stated at the outset, we believe this bill evidences enough progress that your subcommittee should move forward and avoid another extension of the present moratorium.

Thank you for the opportunity to present our views here today. If we can be of further assistance, if you would like expansion or clarification of our views, please feel free to ask.

## COMPARISON OF VARIOUS FRINGE BENEFIT PROPOSALS APPLIED TO MORE COMMON BENEFITS—PREPARED BY TOUCHE ROSS & CO.

| Type of benefit | 1981 Treasury draft | 1975 Treasury draft | 1979 AICPA proposal | 1980 ABA proposal | H.R. 3525 |
|---|---|---|---|---|---|
| 1. Airline discounts | Taxable, unless discount does not exceed lesser of 20 percent of price available to public or $100 per item. | Nontaxable—general rule. Applies to flights on employer's airline as well as flights on other airlines with which employer has reciprocal arrangement. | Nontaxable—general rule. Applies only to flights on employer's airline. | Nontaxable—incident to employer's trade or business. | Nontaxable—if provided on nondiscriminatory standby basis on employer's airline for current or former employees working in airline business (or their spouses or dependent children). |
| 2. Airline discounts to travel agents. | Unclear if applies to independent contractor. Reference is to one rendering services, not to "employee". | Nontaxable—general rule. | Proposals do not apply to independent contractors. | Unclear if applies to independent contractor. Reference is to one rendering personal services, not "employee". | Bill does not apply to independent contractors. |
| 3. Employee discounts | Taxable, unless discount does not exceed lesser of 20 percent of price available to public or $100 per item ($200 total discount if of a recurring nature, e.g., phone service). | Nontaxable—general rule. | Nontaxable—general rule. | Nontaxable—incident to employer's trade or business. | Nontaxable—if provided on nondiscriminatory basis to current or former employees (or their spouses or dependent children) working in the same business and to the extent does not exceed lesser of (a) 20 percent of employer's sale price or (b) markup. |
| 4. Interior decorators buying for personal account at wholesale. | Unclear whether proposals apply to independent contractors. | Nontaxable—general rule. | Proposals do not apply to independent contractors. | Unclear whether proposals apply to independent contractors. | Bill does not apply to independent contractors. |
| 5. Company airplane: | | | | | |
| a. Primarily personal usage by employee and spouse—no business reason for plane to make the trip. | Taxable—income—charter cost of equivalent flight. | Taxable—facts and circumstances. Income—charter costs of equivalent flight. | Taxable-income—lower of allocated cost or charter cost of equivalent flight. | Taxable—income—charter cost of equivalent flight. | Presumably taxable. |
| b. Primarily personal usage by employee and spouse—valid business reason for plane making the trip (i.e., hitchhiking). | Taxable—income—cost of two first-class, reserved seat tickets on a scheduled commercial flight. | Nontaxable—general rule | Probably nontaxable—income—lower of employer's incremental cost of 3rd party equivalent cost. De minimis rule probably applies. | Nontaxable—incident to employer's trade or business. (If made available on nondiscriminatory basis). | Presumably taxable. |
| c. Facts same as 5(a), except secretary accompanies employer to perform work while on flight. | Probably nontaxable to secretary—working condition. | Nontaxable—general rule | Nontaxable to secretary—deductible travel expenses of an employer for an employee's business trip is not a fringe benefit. | Nontaxable to secretary—for benefit of employer. | Nontaxable—working condition. |

| | | | | | |
|---|---|---|---|---|---|
| d. Facts same as 5(c), except secretary's mother accompanies her. | Taxable as to mother's travel | Nontaxable—general rule | Taxable as to mother's travel—immediate family includes only employee, spouse, and dependent children. Incremental cost formula applies and may result in exclusion under the de minimis rule. | Nontaxable—incident to employer's trade or business. | Mother's travel presumably taxable to secretary. |
| 6. Hitchhiking family or friends on a company airplane. | Taxable to employee | Nontaxable—general rule | Taxable to employee—incremental cost formula applies and may result in exclusion under the de minimis rule. | Nontaxable—incident to employer's trade or business. | Presumably taxable to employee. |
| 7. Taxi fare to and from unsafe area. | Nontaxable—working condition. (Query—can working conditions be discriminatory?). | May be nontaxable under facts and circumstances test. Important factors—safety and general availability to similarly situated employees. | Probably nontaxable—general rule 3 (availability on non-discriminatory basis) and Special rule 3 (safety). | May be nontaxable—incident to employer's trade or business. | Nontaxable—working condition. |
| 8. Supper money and night taxi *fare for overtime.* | Nontaxable—working condition | Nontaxable under facts and circumstances test. Important factors—employer's business requirement, proximate relation to overtime period. | Probably nontaxable. General rule 3 (non-discriminatory application) and Special rule 2 (employer's business requirement) or Special rule 3 (safety). | May be nontaxable—incident to employer's trade or business. | Nontaxable—working condition or de minimis. |
| 9. Chauffeured limousines for executives: | | | | | |
| a. Commuting | Taxable | Taxable | Taxable | Taxable | Presumably taxable. |
| b. Office to business appointments. | Nontaxable—working condition | May be nontaxable under facts and circumstances test. Important factors—needs of employer and proximate relation to executive's work. (Query: Is a reasonable classification necessary?). | May be nontaxable—general rule 3 (reas. class.) and special rules 1 (working cond.), 2 (important bus. reg.), or 3 (safety). | Nontaxable—for benefit of employer. | Nontaxable—working condition. |
| 10. Parking spaces | May be nontaxable under special rule for administrative convenience—reas. classification. | May be nontaxable under facts and circumstances test. Important factors—reasonableness of classification and employer's business requirement. | May be nontaxable—general rule 3 (reas. classification) and special rules 1 (working condition), 2 (bus. requirement), or 3 (safety). | May be nontaxable—incident to employer's trade or business. (i.e.—if space provided because employees need car for business purpose during office hours or excess parking. | Nontaxable—if made available on nondiscriminatory basis. |

### COMPARISON OF VARIOUS FRINGE BENEFIT PROPOSALS APPLIED TO MORE COMMON BENEFITS—PREPARED BY TOUCHE ROSS & CO.—Continued

| Type of benefit | 1981 Treasury draft | 1975 Treasury draft | 1979 AICPA proposal | 1980 ABA proposal | H.R. 3525 |
|---|---|---|---|---|---|
| 11. Ambassador's automobile and chauffeur. | Any personal use—probably taxable. | Probably nontaxable under facts and circumstances test. | Taxability depends on facts and circumstances. May satisfy general rule 3 (reas. class.) and special rule 3 (safety). | May be nontaxable—incident to employer's trade or business. | Nontaxable—working condition. |
| 12. Fire chief's automobile | Any personal use—probably taxable. | May be nontaxable under facts and circumstances test. Important factors—prox. relation to work, employer's requirement. Occasional personal use—de minimis. | May be nontaxable. General rule 3 (reas. class.) and special rules 1 (prox. relation to work) or 2 (employer's bus. requirement). | May be nontaxable—incident to employer's trade or business or for benefit of employer. | Nontaxable—working condition, if personal use does not exceed 15 percent. |
| 13. Limousine for safety reasons, bodyguards, security facilities. | May be nontaxable as a working condition. | Probably nontaxable—facts and circumstances. | May be nontaxable—general rule 3 (reas. classification) and special rule 3 (safety). | May be nontaxable—incident to employer's trade or business. | Nontaxable—working condition. |
| 14. Automobiles used primarily for personal use. | Taxable—income—cost of leasing same model in arm's length transaction. | Taxable—income—cost of leasing same model in arm's length transaction. | Taxable—income—lower of allocated cost or 3d party leasing cost. | Taxable | Taxable. Deduction for business use. |
| 15. Automobiles where primary use is job-related—occasional personal use. | Occasional personal use during business hours—nontaxable under special rule for administrative convenience. Personal use during non-business hours—taxable. | May be nontaxable under general rule—employer incurs no substantial additional cost for employer's personal use. | Taxable for personal use. Incremental cost formula may result in exclusion under de minimis rules. | Nontaxable—administratively impractical to account for it. | Nontaxable—if personal use does not exceed 15 percent. |
| 16. Typing of personal letters | Probably nontaxable under administrative convenience rules. | Nontaxable—de minimis | Probably nontaxable under de minimis rules. | Nontaxable—administratively impractical to account for it. | Nontaxable—de minimis. |
| 17. Professional dues, et cetera | Taxable—business expense deduction to employee. | May be nontaxable under facts and circumstances test or de minimis rule. | May be nontaxable. General rule 3 (reas. classification) and special rule 2 (important business reason by employer). | Taxable—business expense deduction to employee. | Presumably taxable business expense deduction to employee. |
| 18. Company parties | Probably nontaxable under special rule for administrative convenience. | Probably nontaxable—facts and circumstances or de minimis. | Probably nontaxable. General rule 3 (reas. classification) and special rule 2 (important business reason of employer). | Nontaxable—recreational benefit to employees. | Nontaxable—de minimis. |
| 19. Day care centers for employee's children. | Taxable | Taxable | Taxable—primarily personal item rather than employer requirement. | Taxable | Nontaxable if requirements of section 129 are met. |

| | | | | | |
|---|---|---|---|---|---|
| 20. Tuition subsidies by university to employees and their families. | Taxable | Probably nontaxable—general rule | Nontaxable—general rule. Applicable only to school where employed. | May be nontaxable—incident to employer's trade or business. | Nontaxable—if nondiscriminatory; applicable only to school where employed; postgraduate study precluded. |
| 21. Executive dining rooms | May be nontaxable as under administrative convenience rules. Although nondiscrimination may be a factor. | May be nontaxable under facts and circumstances test. | May be nontaxable—general rule 3 (reas. classification) and special rule 2 (important business requirement of employer). | May be nontaxable for benefit of employer (under limited circumstances). | Nontaxable—working condition. |
| 22. Open cafeteria | Probably nontaxable under administrative convenience rule if charges cover direct costs. | May be nontaxable under facts and circumstances test. | May be nontaxable depending on facts and circumstances. General rule 2 (no additional cost to employer) or general rule 3 (reas. class.) and special rules 1 (working condition), 2 (bus. reg.), or 3 (safety). | May be nontaxable as incident to trade or business if for benefit of employer (under limited circumstances). | Nontaxable—de deminis. |
| 23. Free investment advice and counseling. | Taxable | Taxable | Taxable | Taxable | Taxable. |
| 24. On site emergency health unit care. | Nontaxable—working condition | Nontaxable—facts and circumstances test. | May be nontaxable—general rule 3 (reas. class.) and special rule 3 (safety). | Nontaxable—for benefit of employer. | Nontaxable—working condition. |
| 25. Cab fare for sick or injured | Nontaxable—working condition | Nontaxable—facts and circumstances test. | May be nontaxable—general rule 3 (reas. class.) and special rule 3 (safety). | Nontaxable—for benefit of employer. | Nontaxable—de minimis. |
| 26. Office redecoration | Nontaxable—working condition | Nontaxable—facts and circumstances text. | May be nontaxable—general rule 3 (reas. class.) and special rule 1 (working condition). | Nontaxable—incident to trade or business. | Nontaxable—working condition. |
| 27. Onsite gymnasium | May be nontaxable (depending on facts and circumstances) under administrative convenience rules. | Nontaxable—general rule | May be nontaxable under general rule or general rule 3 and special rule 1 (working condition). | Nontaxable—recreational | Nontaxable—if employer limits deductions attributable to gymnasium to income earned from operation of gymnasium. |

Chairman **Stark**. Thank you very much.

I have a question, several questions for the panel, but perhaps you could enlighten me. Several of you mentioned self-employed contractors. Can you give me an example of what goes on there? I am missing something. I do not quite understand. The guy that runs the filling station——

Mr. **Odmark**. For example, the self-employed construction contractor who is not incorporated works in the same business with the employee carpenters. If the employees received parking at the job sites and the contractor got parking also with all the carpenters, there is a question whether the person in charge, because he is self-employed, would be covered. He is not technically an employee, where the carpenters would be employees and they would be covered.

Chairman **Stark**. When I see construction, the guys are usually parking in the street where I want to get by.

Mr. **Odmark**. In San Francisco they give them parking downtown in the garages for example as part of the deal in the contract.

Chairman **Stark**. What about the big areas of independent contractors, real estate agents, insurance agents, door-to-door salespeople? Is that an issue?

Mr. **Odmark**. The independent contractor problem goes on from there. The first would be an example of where the self-employed person and his employee perhaps should receive comparable type benefits. The next would be independent contractors.

Chairman **Stark**. Give me an example.

Mr. **Odmark**. The carpenters who work for the construction contractor or the CPA's that work in a CPA firm.

Mr. **Delaney**. Or the lawyers that are partners in a law firm.

Chairman **Stark**. What kind of fringe benefits ought they to get that they do not? What does a partner in Touche Ross get that the brand new accounting graduate does not get or vice versa?

Mr. **Padwe**. It would be primarily a matter of degree. Being partner in a firm, we are not entitled to a number of fringe benefits that our employees are, because the tax law permits certain benefits to employees, and we as partners are self-employed.

Chairman **Stark**. So they are taxed——

Mr. **Padwe**. They are taxed less, that is right.

Chairman **Stark**. Can you give me a hint as to what goes on? Health insurance?

Mr. **Padwe**. If not health insurance, there is at least a question inso far as deductibility of life insurance for partners up to $50,000.

Mr. **Delaney**. TEFRA did try to establish parity between the self-employed and employees, and what we are suggesting is that that continue through in this area as well.

Chairman **Stark**. Mr. Delaney, why should the tax laws encourage employers to provide items or services unrelated to their own business such as the new cafeteria? You object to the part in the bill requiring that the fringe benefit be a product or service offered to the business's customers. You suggest we eliminate that restriction. It seems to me you are opening the way for, and encouraging employers to provide employees with tax-free premiums as a way to give them more tax-free compensation. I just wonder if we ought to do that.

Mr. DELANEY. We suggest that it be incident to the business, and we suggested as an example the military PX, that the military PX is not part of the Army's or military's trade or business, we assume, and we therefore believe that the discount, if offered, ought to be treated the same—they at least ought to have that opportunity for that discount.

Chairman STARK. It seems to me that fringe benefits received by the military, such as PX's are dealt with under separate rules and regulations.

Mr. DELANEY. We cite that as an example. We think the rule is too stringent here, that it must be incident to the business. We have also suggested that the Secretary be granted a broader authority in the definition of the employee-employer area, and let him exercise that discretion to solve some of these problems.

Mr. FLIPPO. Would the distinguished chairman yield?

Chairman STARK. Be glad to.

Mr. FLIPPO. If a textile firm, Mr. Delaney, that provided a swimming pool and a softball field to its employees, would that be a fringe benefit that is in the normal trade or business of the textile firm? Would that be an example for the chairman's question as to how a company could furnish a fringe benefit that is not in the normal course of business?

Mr. DELANEY. We believe that that one is already included under the recreational facility, and we do have some question about the recreational-facility rule of the proposed bill. We would believe that that ought to remain under the existing recreational-facility rule.

Mr. FLIPPO. Is it your understanding that H.R. 3525 would permit the continuation of recreational facilities of the nature that I described?

Mr. MARINIS. It would permit the continuation of the exclusion of the employee, but I believe the employer would lose his deduction for those facilities.

Mr. FLIPPO. Thank you, Mr. Chairman.

Chairman STARK. Mr. Dorgan.

Mr. DORGAN. Mr. Chairman, I have a question that does not deal with the specifics of the testimony. I do not have any idea whether any of you gentlemen can respond to it. But last evening I was reading again some information about the firms in Japan and the benefits that they provide to their workers. There are a lot of stories about some of the major corporations in Japan having amusement parks available to their employees, having essentially a lifetime contract with their employees, and providing all sorts of different kinds of fringe benefits for them. I do not know what the tax consequences are of that in Japan. Do any of you have any idea how Japan goes about taxing fringe benefits, especially in light of as much information about the fringe benefits they provide? The reason I ask, I was asking one of the staff back here whether we had any information. It might be interesting to see how they deal with it.

Thank you, Mr. Chairman.

Chairman STARK. I have just one more question that I would ask the panel, any or all of you. I am sorry—Mr. Duncan.

Mr. DUNCAN. That is all right.

Chairman **Stark**. We think that there might be an area here, although with a tremendous amount of controversy in which it would be appropriate to institute some kind of reporting requirements so that in future years the job of evaluating this will be easier for the subcommittee. We really do not know the extent of the revenue loss or gain, and it seems to me that we might, for whatever fringes are allowed, require some kind of reporting so that after a few years we would have an idea of the accurate amounts. Do any of you have any ideas of how that might be done simply and easily?

Mr. **Delaney**. I do not know that we can tell you how to do it simply or easily, but that is a recommendation that the bar association has made, that there not be withholding but an increase in reporting and an increase in the penalties. I have not had an opportunity to check to see if those changes that have been made recently are adequate or would touch on the point or not, but it ought to be looked at in our view.

Mr. **Odmark**. I think they mean reporting on tax returns, even if not taxing, reporting the amount for statistical purposes. I do not think it would be easy. Something similar was tried in the travel area a few years back, and the larger companies or any of them who tried to provide that information on a conscientious basis spent tremendous amounts of time compiling the information. We did not have to deal with the problem of what the value was. Any one of the nontaxable benefits, if you were going to compute what the amount is on a fair-market-value basis, you have to deal with all the problems that when they are exempt that you do not have to deal with. So I think it would be a large bookkeeping problem.

Chairman **Stark**. I do not know why. Could you name the service or the product? Discounts could be listed in a retail establishment. They write up a sales check and it would be easy to look at the sales discount granted.

Mr. **Odmark**. Retail is easy, but coffee, the fair market value of the coffee they drink.

Chairman **Stark**. We pay for coffee each month.

Mr. **Odmark**. That is the cost, but what is the coffee worth in your office versus across the street?

Chairman **Stark**. We might find out how much coffee is consumed. If I sold it at 50 cents a cup I think I would make a profit. The point is that you would get some indication of the magnitude of the use of fringes and some relative indication of the value. We might have to make some decisions as to what the true value was to the recipient, but it certainly would seem to me that if that information exists, we should have it. There is some information if the people are doing a conscientious job of recordkeeping now, is there not?

Mr. **Odmark**. If you used original cost or cost to employer as opposed to fair market value it would ease the burden. If you excluded certain working benefit fringes, the value of sitting in a nice office or the coffee, certain things like that, it would make it easier to go after the large-ticket items.

Chairman **Stark**. I thank the panel. Particularly Mr. Padwe, for the trouble that Touche Ross went to make the chart which the chair was reviewing. I found it very informational.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Congressman Gradison, the first witness today testified about a cap instead of a percentage basis on wages earned. Would any of you care to comment on whether or not we should base a limitation on a cap of so much money or a percentage of wages?

Mr. Padwe.

Mr. PADWE. I heard Congressman Gradison's point. I have a feeling that if you were going to go in that direction you would probably want to do some kind of an alternative approach. One question that came to mind as he spoke was whether or not there would be an index on that cap? I keep thinking of things like the $25 T&E substantiation requirement that was put in the code back in 1962, was it, that is still $25 today. A top-dollar-limit cap can become a much smaller cap a few years down the road. Mr. Gradison's point is clearly worth consideration, but I think you should undertake a good deal of analysis to make sure you are equitable to all levels of employees by putting in this type of cap. Also I think you have got to take a look at how a cap on these so-called nonstatutory fringes ties in with the statutory fringes that are already in the code, cafeteria plans and so forth, in making any final determination.

Mr. DUNCAN. Would any other member of the panel care to respond? Or you may be in substantial agreement?

Mr. ODMARK. Yes, sir. The problem I would see there would be similar to the problem of just reporting the total amount of these benefits in that a number of the benefits would now have to be calculated on a fair-market-value basis and done by employee in order to determine whether they had met the cap or not, and this would be a very large bookkeeping burden on the firms that had to do it. It would make the firms have to pay the costs of doing this bookkeeping.

Mr. PADWE. It is a little similar to a problem caused by something that is already in the bill, the de minimis rule. That rule excludes from income any fringe so small that it does not make sense to try and account for it. But then, the next sentence in the bill says, on the other hand, we will determine de minimis in the aggregate for every employee every year. When something is so small that it becomes administratively impractical to account for it, how does one now account for it because 5 or 10 such items were given an employee in a year. I think, in a broader context, the same kind of problems would arise trying to put caps of fair market value on the overall picture.

Mr. DELANEY. We did raise a serious question about the inadequacy of the de minimis rule. It will I think present a major problem of administration, and we had urged that that be eliminated and we have used a $50 item as de minimis.

Mr. DUNCAN. Would any of you envision problems in an industrial plant which employs thousands of industrial workers, where there are many so-called fringe benefits? I know I have a plant that claims that their fringe benefits to their industrial workers—I do not know what all they are—runs as much as $1,000 a month on the average per industrial worker, not the management, not office help, but other fringes. Would any of you envision problems under this bill?

Mr. WALKER. I think that the result of course, Congressman, will vary from industry to industry and from business to business. And the—I think that obviously some will be affected more than others, depending upon the practices which they follow and to the extent to which the various fringe benefits have become an overall part of the compensation package. So I think that to answer your question specifically yes, particularly with some industries, I think that we would have to do some study on it to determine which ones would be more affected than others, but I think some would be severely affected, but in general terms I would recommend that legislation of this type at this time, this particular time, not be infused into 3525 to lessen its overall thrust and chances of passing, because I think if such an amendment were tacked onto it, it would certainly make it a much more controversial bill and greatly diminish its intent.

Mr. DUNCAN. Thank you very much, gentlemen.

Thank you, Mr. Chairman.

Chairman STARK. We thank the panel very much.

The next panel is Steve Koplan of the AFL-CIO, Richard Fay, chamber of commerce, and Paul Howard, vice president of the National Association of Manufacturers.

I am used to seeing you all together.

Steve, you are first on the list. Do you want to lead off?

## STATEMENT OF STEPHEN KOPLAN, LEGISLATIVE REPRESENTATIVE, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. KOPLAN. Yes, I do. Thank you, Mr. Chairman.

I will not read the full text of my statement, but ask that the full text be included in the record.

Mr. Chairman, the AFL-CIO appreciates this opportunity to present its views on H.R. 3525, "The Permanent Tax Treatment of Fringe Benefits Act of 1983." In general, the AFL-CIO believes this bill represents a reasonable approach to a very difficult problem. We do have strong objections which we would like to express concerning some of the specifics in the bill. And, we would be less than candid if we did not express some concern for the manner in which this legislation, however reasonable, might be perceived in view of the Congress' unwillingness to tackle the major inequities in our tax laws. Those inequities favor big business and the very wealthy. They include recent actions such as the failure to cap the third year of the administration's 1981 tax cut and the likely repeal of withholding of taxes on interest and dividends. Thus, in terms of making the tax code fairer and in terms of raising revenues, the major opportunities have been foiled. Congress' attention here to the so-called fringe benefits of employees is, to us, at the bottom end of priorities in terms of taxation and tax expenditures.

In December 1979 the AFL-CIO convention set forth some general standards with respect to the taxation of fringe benefits. The convention urged that the Congress should establish guidelines for the taxation of fringe benefits based on such principles as:

First, sensible de minimis rules so that employers and employees need not take into account small benefit values which would cause unreasonable recordkeeping and administrative burdens.

Second, benefits that facilitate the employee's work performance, are provided for the convenience of the employer, or other support services, such as the furnishing of uniforms should not be taxed.

Third, limited benefits historically and broadly available such as discounts for employees of retail stores should be exempt from taxation.

Fourth, provisions of present law which under specified conditions expressly grant tax exemptions for fringe benefits including, among others, qualified pension plans, group life insurance, health benefits, and group legal services should be continued.

The convention also stated that:

> * * * any measures to change current practice be considered within the context of an overall program of tax justice—a program which fully addresses the tax avoidance opportunities of the wealthy and the corporations and does not add to the already unfair share of the tax burden borne by workers.

Absent such a coordinated approach, the convention recommended a further moratorium on the IRS from issuing new regulations on the taxation of employee fringe benefits.

We are pleased that in their introductory remarks, the sponsors of this proposal made note of the compelling public policy for exempting benefits like health insurance from their bill.

The Nation's working people have already been forced to bear a disproportionate part of the burden of a recession caused by tight money and the tax giveaways legislated in 1981, as the persistence of high unemployment demonstrates. Instead, strengthening the Nation's tax base must be conducted in a comprehensive fashion. In that light, the AFL-CIO supports H.R. 3585, a bill to raise revenues through tax reform, introduced by Representative Thomas Downey, which would recapture more than $120 billion over the next 3 years.

H.R. 3525 proposes to establish four categories or criteria for fringe benefits which would not be taxed.

One, when the employer incurs no substantial additional cost and forgoes no revenue in providing a product or service to an employee, the entire value of the benefit may be excluded from gross income.

Two, discounts of up to 20 percent on other goods and services offered to customers and provided to employees would be excluded.

Three, working condition fringe benefits provided in connection with the employee's job are to be excluded.

Four, de minimis fringe benefits, such as a company picnic, Christmas gifts of small value and so forth, are also excluded, because benefits of this nature are of such small value that accounting for them is impractical.

In addition to these four major categories, several special rules are proposed which recognize some special circumstance where there are major difficulties in valuation and/or making distinctions between working conditions and personal use. Thus, under the bill, auto salesmen would be allowed demonstrator cars for limited personal use and parking facilities, if available to employees on a nondiscriminatory basis, would not be taxed. Another special provision in the bill excludes certain tuition reductions that are provided by and at a school or college to its employees, or their spouses or children.

The legislation restricts most of the eligibility for tax exclusion to situations in which there is no discrimination in the availability of a benefit to employees. In particular, this rules out benefits set up by the employer that discriminate in favor of officers, owners, or other highly compensated employees. We believe this promotes fairness, and we hope that this would lead to more vigorous enforcement of the rules applying to executive perqs.

Three categories of tax-excluded benefits that would be established by H.R. 3525 conform fairly well with the principles outlined by the AFL–CIO convention. A special concern to working people is that items or services provided by the employer to facilitate the employee's work not be considered to be taxable income to the employee, and we are pleased to see that the legislation seems to cover our concerns in that area and would, therefore, assure that employer-provided safety equipment, uniforms, and the like would not be taxed. We do, however, urge the subcommittee to hear all views on such benefits and practices to assure that there are no disruptive changes in existing working conditions or inequities inadvertently added to the tax code.

We do object to the 20-percent maximum limitation used in the section applying to qualified employee discounts. This is both arbitrary and inconsistent with the no additional cost criteria used to determine the qualification of other benefits for employees in other industries.

It is our view that the 20-percent cap is inappropriate and the nondiscriminatory criteria and the provisions which generally limit discounts to the employer's profit margin would be sufficient to avoid abuse and serve the intent of this legislation in a more consistent fashion.

We are also concerned with the adverse impact of the proposed legislation with regard to reciprocal arrangements whereby employees of one organization receive a benefit from another employer. This provision would adversely affect longstanding and long-accepted working conditions of many employees of airlines and educational institutions, and in our view, singles out a particular group of workers for unduly harsh treatment and sudden change in past practice. A fundamental justification for this proposed termination appears to be the concern that otherwise there would be no limit to the availability of these provisions and abuse would be widespread.

We feel, however, that such reciprocal arrangements could be constrained in a satisfactory and reasonably consistent fashion by limiting them to the same product or service and adhering to nondiscriminatory rules. Thus, airline travel would be eligible for exclusion from taxation if provided by the airline providing employment or by another airline, and tuition benefits would be eligible if provided by the educational institution providing employment or by another educational institution.

In sum, Mr. Chairman, with these qualifications we support the intent of H.R. 3525—to establish uniform guidelines and criteria which accommodate most existing practices pertaining to the taxation of fringe benefits. We do urge that you proceed cautiously in this area so that you do not heap an ever larger share of the tax burden onto workers and add to inequities.

Thank you, Mr. Chairman.

Chairman STARK. Thank you.

[An attachment to the statement follows:]

### RESOLUTION ADOPTED BY THE THIRTEENTH CONSTITUTIONAL CONVENTION OF THE AFL-CIO, WASHINGTON, D.C., NOVEMBER 15-20, 1979

#### TAXATION OF EMPLOYEE FRINGE BENEFITS

In August 1977, in response to controversy surrounding Treasury and IRS proposals for rules regarding the taxation of employee fringe benefits, the AFL-CIO Executive Council opposed "piecemeal changes in regulations, aimed at taxing some of America's lowest paid workers . . ." and urged concentration on assuring that those of great wealth "pay their fair share of the tax burden."

Late in 1977 the Congress enacted legislation preventing the IRS from issuing any new regulations until 1980. That issue remains unresolved and legislation is now pending to extend the prohibition on IRS action.

The AFL-CIO supports this pending legislation which would prohibit IRS action until Congress establishes necessary statutory guidelines and urges that such guidelines be based on principles such as:

1. Common sense "de minimus" rules that assure no unreasonable recordkeeping, administrative, or tax burdens.
2. Limited benefits, generally and historically available to employees, such as discounts for retail store employees, should not be taxed.
3. Benefits provided by the employer that are necessary to the performance of workers' duties or are provided for the employers' convenience, such as uniforms, should not be taxed.
4. Present statutes, which expressly grant exemption under limited circumstances for benefits such as qualified pension plans, group life insurance, employee death benefits, educational assistance programs, moving expenses, and meals or lodging, which are provided for the convenience of the employer should continue.

Finally, we insist that any measures to change current practice be considered within the context of an overall program of tax justice—a program which fully addresses the tax avoidance opportunities of the wealthy and the corporations and does not add to the already unfair share of the tax burden borne by workers.

Chairman STARK. Mr. Fay.

## STATEMENT OF RICHARD H. FAY, MEMBER, EMPLOYEE BENEFITS POLICY COMMITTEE, CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY DAVID E. FRANASIAK, MANAGER, TAX POLICY CENTER

Mr. FAY. Good morning. I am Richard Fay, and I am testifying on behalf of the U.S. Chamber of Commerce. With me is Mr. Franasiak, manager of the chamber's tax policy center.

The chamber welcomes this opportunity to testify and welcomes the introduction of H.R. 3525, which attempts to solve the longstanding riddle of what should be the proper tax policy and treatment of nonstatutory fringe benefits, benefits which we all know are increasingly being offered by employers to their employees.

The current stalemate between Congress and the Treasury on this subject cannot last. Thus the chamber looks forward to working with the members of this subcommittee and the rest of Congress in devising a legislative solution to this most perplexing problem. While we believe the bill is a promising beginning offering a conceptually logical approach, we believe much work, analysis, and refinement will be needed before it or similar legislation can be enacted.

As the members of this subcommittee can appreciate, the chamber has not yet had sufficient time to develop a detailed analysis of the provisions of the bill and their ramifications for business, but let me offer some of our initial observations. Like most of the other witnesses today, we are troubled by the trade or business restriction. Let us give you an example. For example, a person who worked for one company of a holding company for many years but retired from another company of that holding company could not receive a nontaxable benefit from the company for which he worked most of his career. This seems to us unduly restrictive.

Turning to the no additional-cost-service category, we are troubled by the provision that payments made by an employee for the services shall be ignored. This provision turns a fringe benefit which is genuinely provided at no additional cost into a cost item, and undermines the conceptual fairness of this category.

Our initial review of the qualified employee discount category indicates that it creates serious problems of compliance and of excessive recordkeeping which have been adverted to this morning. For many companies we believe the test of whether a product or service meets this category will be a profit margin test. I need not remind the members of this committee that the phrase "profit margin" is easier to say than to determine. In fact, it is not clear if it is possible for a nonprofitable company to offer a discount product or service to its employees.

Turning to the working condition fringe, under the bill providing parking space can be a working condition fringe if it meets the terms of this category, and in addition meets a nondiscrimination test. We question the reason for this additional requirement as we feel that it undercuts the basic justification and purpose of the working condition fringe category.

As to the de minimis category, as has been previously adverted to the aggregation test is inconsistent with the idea of eliminating excessive recordkeeping for minor matters.

In conclusion, we believe that a great deal more attention must be given to the scope of the proposed legislation, and in this regard the chamber believes it would be helpful if the preamble of the bill, among other things, would make it clear that the bill would not automatically require the taxation of every benefit which is not covered by the bill or other sections of the code.

We would like to end by saying this is a reasonable bill; many of the problems we have observed in our testimony and will supplement with additional comments can probably be corrected by modifications to the bill and by legislative history. It is extremely important that such legislation be administered and interpreted with flexibility and common sense, not by rigid adherence to statutory language which has been the traditional approach of the Internal Revenue Service.

Thank you.

Chairman Stark. Thank you, Mr. Fay.

[The prepared statement follows:]

## STATEMENT OF RICHARD H. FAY, ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

My name is Richard H. Fay and I am a lawyer with the law firm of Reed Smith Shaw & McClay. I am appearing on behalf of the Chamber of Commerce of the United States, where I am a member of the Employee Benefits Committee and chairman of that committee's ERISA Subcommittee. With me is David E. Franasiak, Manager of the Chamber's Tax Policy Center. We are here today to present the Chamber's initial views on the proposed tax treatment of non-statutory fringe benefits as set forth in H.R. 3525, the Permanent Tax Treatment of Fringe Benefits Act of 1983.

We wish to commend the drafters of H.R. 3525 for the skill and care they used in developing this very important bill. We welcome the subcommittee's efforts to provide clear and concise rules governing the tax treatment of non-statutory fringe benefits. H.R. 3525 represents a start to what we hope will be a full and detailed consideration of the tax policy and tax compliance issues implicit in the current tax treatment of non-statutory fringe benefits.

It will take many months to analyze thoroughly the effects of H.R. 3525 on the business community and to recommend needed revisions. Employers need time to assess the far-reaching impact of this legislation. Questions concerning increased cost to employers, the need for additional reporting and recordkeeping, the feasibility of enforcing some of the provisions of H.R. 3525, and their cost-effectiveness need to be thoroughly evaluated before any legislation is enacted.

Furthermore, additional hearings on H.R. 3525 or similar legislation should be held by the Subcommittee as various aspects of H.R. 3525 are clarified and refined. If it is not possible to complete this necessary review and revision by December 31, 1983, we recommend that the moratorium on the tax treatment of fringe benefits, scheduled to expire on December 31, be extended to allow further work and action by the Subcommittee and Congress. In recommending a moratorium, if necessary, we are not suggesting that this Subcommittee lessen its work on H.R. 3525 or similar legislation. We believe that appropriate legislation will result from these efforts.

### GENERAL DESCRIPTION OF H.R. 3525

H.R. 3525 provides new rules for the tax treatment of those fringe benefits not specifically covered by other provisions of the Internal Revenue Code. Generally, a taxpayer's gross income would not include any fringe benefit which qualifies as (1) a no-additional-cost service; (2) a qualified employee discount; (3) a working condition fringe; or (4) a de minimis fringe. These benefits also would be excluded from wages and benefits subject to social security or other employment taxes. The provisions of the bill generally would take effect on January 1, 1984.

A more detailed description of the bill is to be found in the Congressional Record of July 12, 1983 at page H5056 as well as the appendix to our statement.

### GENERAL COMMENTS

We urge that a preamble be added to the bill that will clearly explain the scope of the bill and provide a statement of purpose. The rules contained in H.R. 3525 should be reasonable and flexible, not strict standards. It should be made clear that the bill does not automatically require taxation of every fringe benefit which is not covered by H.R. 3525 or other sections of the tax code. Since it is impossible to treat each and every fringe benefit, the preamble should make it clear that the intent of H.R. 3525 is not to reverse or suspend prior revenue rulings or existing case law dealing with fringe benefits not covered by this bill.

The Chamber has not had time to develop a detailed analysis of the provisions of H.R. 3525 and their ramifications for business, but a few observations about the bill should indicate the potential problems.

It hardly needs to be stated that H.R. 3525 raises difficult problems of what is proper valuation of the fringe benefit provided. Perhaps a total solution to the valuation problem is not possible, but Congress should be aware that simplicity of statutory rules is not automatically translated into simplicity of application of those rules. Neither does simplicity of rules necessarily produce logical, cost-effective results. In some circumstances the rules set forth in H.R. 3525 will produce hardship and unnecessarily restrictive administrative rules or require difficult or burdensome recordkeeping and calculations. A great deal of thought needs to be given to how the four nontaxable categories of H.R. 3525 will be administered and interpreted.

We also need to know more about how the non-discrimination test would be interpreted and administered before informed comment is possible. Many fringe benefits, by their very nature, cannot be made available to large groups of employees. A great deal of common sense and flexibility will be necessary and must be used in implementing this test. An attempt to track the anti-discrimination test developed for qualified employee benefit plans would be unworkable.

Also troubling is the trade or business limitation in order for a fringe benefit to qualify as either a non-additional-cost service or a qualified employee discount. Under this requirement, the employee receiving the property or service must be employed in the business or trade of the employer normally providing such property or service. The harshness of this requirement is highlighted by the fact that former employees are also subject to this limitation. Thus, employees who worked most of their careers for one company owned by a parent company, but retired from a different company of the parent company would not be able to receive a product or service at a discount produced by the company where they spent most of their working lives. Also, this requirement assumes that most, if not all, of a company's activities can be separated into a separate trade or business. This is just not true. Many members of the Chamber have several lines of business. For example, a conglomerate may have a retail company, a manufacturing company and a financial services company. It should be made clear that the employee of the manufacturing company can receive a nontaxable fringe benefit provided by the financial services company. Failure to ease this trade or business requirement can only lead to tortuous interpretations of what constitutes a trade or business, a term already far from being clear.

### COMMENTS ON NO-ADDITIONAL-COST SERVICES

The bill defines an excludable no-additional-cost service as any service provided by an employer to an employee for use by such employee, the employee's spouse, or dependent child, if the services is provided to customers in the ordinary course of the employer's trade or business in which the employee works and if the employer incurs no substantial additional cost (including foreign revenue) in providing the service, determined without regard to any amounts paid by the employee in providing the service.

The valuation of a no-additional-cost service category is made particularly harsh and unfair, so it seems to us, by providing that in determining if a fringe benefit is a no-additional-cost service, payments made by an employee to reimburse the employer are ignored. This aspect of H.R. 3525, treating the provision of a service that genuinely involves no substantial cost to the employer as though it had such a cost, greatly weakens the fairness of the no-additional-cost service category.

### QUALIFIED EMPLOYEE DISCOUNT

The bill defines an excludable qualified employee discount as the discount provided to an employee, the employee's spouse, or dependent child on property or services offered to customers in the ordinary course of the employer's trade or business in which the employee works, to the extent such discount does not exceed 20 percent of the retail price at which the discounted item is offered for sale by the employer to customers. If the employer's average profit is less than 20 percent, the amount of discount excludable from income could not exceed this average percentage.

An initial review indicates that this category creates serious problems of compliance. The establishment of a limitation on the amount of the discount, which is the lesser of 20 percent or the actual profit margin of the employer, means for many, if not most, employers the creation of a profit margin test, since many will find that their profit margin is well below 20 percent. A profit margin is much easier to say than to determine, indeed, even to achieve. In fact, it is unclear in the bill whether an unprofitable firm would be allowed to offer a retail discount at all.

Furthermore, in certain industries, such as the financial services industry, there is no universal method for calculating profit margins. The effect of H.R. 3525 will be to require elaborate recordkeeping procedures on employers providing discounts. Perhaps a better approach which would avoid undue complexity and would establish the 20 percent standard as a safe harbor in all events, and permit a larger discount where the profit margin could be demonstrated as exceeding the 20 percent safe harbor level. H.R. 3525 would require employers to compute profit margins and prices in the year in which the fringe benefit is offered to the employee. This will be impractical and should be changed to allow the use of historical averages. Both profit margins and prices can greatly fluctuate over time. Furthermore, both cannot be determined for any one year until the company's fiscal year is complete and the books are closed. Finally, we would report our observations about the troublesome limitation to "trade or business" of the employer.

### WORKING CONDITION FRINGE AND DE MINIMIS FRINGE

The bill defines an excludable working condition fringe as any property or services which are provided primarily for the purpose of facilitating the employee's performance of service for the employer, but only if substantially all of the use of the property or services reasonably can be expected to occur in connection with the employee's performance of services. Under a special rule, the use of an automobile by a sales representative would meet the latter use requirement if there are substantial restrictions on personal use. In addition, free or reduced cost parking would be treated as an excludable working condition fringe only if such parking is available on substantially the same terms to each member of a group of employees defined under a reasonable classification that does not discriminate in favor of officers, owners, or highly compensated employees.

The bill defines an excludable de minimis fringe as any property or services whose value is so small as to make accounting for it unreasonable or administratively impractical. In determining whether the value of such property or services is small, all small-value property or services provided to an employee in a calendar year would be aggregated.

The employer working condition category should be scrutinized to clarify what constitutes a working condition fringe benefit. Until you can determine what is a working condition fringe, it is impossible to apply the 15 percent personal use test. Furthermore, a similar comment could be made with respect to the de minimis fringe benefit category. Also, we recommend that the 15/85 percent test be modified so that an employee can use a property, such as an automobile, more than 15 percent on personal business and still have a certain portion of the use of that property be considered a nontaxable fringe benefit, instead of losing entirely the tax exclusion of the nontaxable benefit.

In light of the desired objective of avoiding taxation of normal business practices designed to serve employer needs, certain rules applicable to parking and recreational facilities are not understandable. For example, the use of a nondiscrimination test that has a fairly long history in the qualified plan context does not make sense for parking because a valid business condition may be treated as a taxable fringe benefit simply because of a greater need of a parking space among higher-paid employees. Greater emphasis should be put on the reasonable classification exception so that it will withstand scrutiny even if there is a disproportionate usage by higher-paid employees.

A denial of a portion of the deduction for recreational facilities is an unwise limitation. We are not aware of any abuse in this area. Furthermore, elimination of the employer deduction would have a discriminatory impact because tax-exempt institutions and currently unprofitable companies would be affected less than profitable companies.

### CAFETERIA PLANS

H.R. 3525 amends Section 125 of the Code to prohibit inclusion of taxable fringe benefits in a cafeteria plan. Thus, H.R. 3525 appears to limit cafeteria plans to nontaxable benefits or cash benefits. As such, many existing cafeteria plans may not qualify since they include group life insurance benefits in excess of $50,000 and/or vacation pay. The case for this restricting approach has not been made.

There is no evidence that employees are confused by the inclusion of both nontaxable and taxable benefits in a cafeteria plan which we understand is the rationale for the proposed restriction. In any case, such alleged confusion is irrelevant since employers handle the tax compliance requirements for a cafeteria plan. Flexible compensation, such as a cafeteria plan, is one of the most positive and encouraging responses to changing work patterns of the American workforce and should be fostered, not stifled.

### SUMMARY

In summary, we wish to reiterate the following points:

(1) While we welcome this effort, we doubt that a thorough and informed legislative evaluation of the numerous questions raised by H.R. 3525 can be completed before the lapse of the current moratorium.

(2) There is simply insufficient information to consider fully at this time the total impact of H.R. 3525. Nonetheless, this bill provides an important focus for discover-

ing the impact of such proposals and a powerful incentive for such a process to take place.

(3) In considering a major change in tax policy, Congress should consider the recent warning of the Congressional Budget Office stated that "although each major option for change has much to recommend it, some major problems would remain under each approach and the transition costs of moving to any significantly different new tax would be great; the more significant the tax, the greater the cost."

(4) Congress should not be misled into believing that every fringe benefit which should be nontaxable is handled by H.R. 3525. For example, the bill does not cover situations where the manufacturer provides direct cash rebates as discounts to employees who purchase the manufactured product from retailers. This is a normal practice and should be addressed.

(5) We look forward to working with the members of this Subcommittee for a satisfactory statutory answer to the question of the proper tax treatment of fringe benefits.

## APPENDIX

## DESCRIPTION OF H.R. 3525, THE PERMANENT TAX TREATMENT OF FRINGE BENEFITS ACT

### A. H.R. 3525 IN GENERAL

H.R. 3525 would exclude from tax (including social security and unemployment tax) only those fringe benefits that meet the terms of one or more of the following new categories: (1) a non-additional cost service, (2) a qualified employee discount, (3) a working condition fringe benefit, or (4) a de minimis fringe benefit. Reciprocal arrangements among industries such as free airplane trips for travel agents would be taxed.

### B. NO-ADDITIONAL-COST-SERVICE

H.R. 3525 provides that if an employer offers a service to an employee the value of the service will not be included in the employee's gross income if the service is: (1) provided on a nondiscriminatory basis; (2) provided at no substantial additional cost to the employer, which includes loss of revenue; (3) the same type of service provided to the public by the employer in the ordinary course of his business; and (4) provided to an employee employed in the trade or business of the employer providing that service.

### C. QUALIFIED EMPLOYEE DISCOUNT

H.R. 3525 provides that if an employer offers property or service at a discount to an employee, the value of that service or property will not be included in the employee's gross income if the service or property is: (1) provided on a nondiscriminatory basis; (2) provided at a discount of no more than 20 percent off the selling price of the service or property; (3) the same property or service offered to the public by the employer in the ordinary course of his business; and (4) provided to an employee employed in the trade or business of the employer which provides such service or property.

When the average markup by the employer on the service or property being offered to the employee is less than 20 percent, the exclusion would be limited to that lower amount. There are additional provisions dealing with workers employed in leased sections of department stores.

For a fringe benefit to qualify as either a no-additional-cost service or a qualified employee discount, the fringe benefit must be available on substantially the same terms to each member of an employee group reasonably defined by the employer so as not to discriminate in favor of officers, owners, or highly compensated employees. Also, the term employee includes any individual who was formerly employed by the employer in the trade or business and who left the employer because of retirement or disability.

### D. WORKING CONDITION FRINGE

H.R. 3525 provides that if an employer provides property or a service to an employee primarily for the purpose of facilitating the employee's work, and substantially all of the use of propety or service can reasonable be expected to occur in connection with the employee's work, then the value of that property or service will not be included in the employee's gross income. Under certain conditions, the use of an automobile by an automobile salesman can qualify as a working condition fringe benefit.

Also, the providing of parking by an employer can qualify as a working condition fringe benefit if such parking is available on substantially the same terms to each member of an employees group reasonably defined by the employer so as not to discriminate in favor of officers, owners, or highly compensated employees.

### E. DE MINIMIS FRINGE BENEFITS

H.R. 3525 provides that a fringe benefit shall not be included in an employee's gross income if the value of the property or service is so small as to make accounting for it unreasonable or administratively impractical. For purposes of determining what constitutes a de minimis fringe benefit, the value of all small property or service provided to an employee during a calendar year shall be aggregated.

### F. OTHER PROVISIONS

(1) Under certain conditions, the value of any on-premises recreational facility provided by an employer to his employees will not be included in the gross income of the employees.

(2) Except for a de minimis fringe benefit, new Section 132 created by H.R. 3525 will not apply to any fringe benefit of a type which is covered by another section of the Internal Revenue Code.

(3) H.R. 3525 amends Section 125 of the Code to prohibit inclusion of taxable fringe benefits in a cafeteria plan.

(4) H.R. 3525 amends Section 117 to provide new terms and conditions in order for a scholarship or fellowship grant to be excluded for an individual's gross income. This provision is effective for education furnished after June 30, 1984, in taxable years ending after such date.

(5) All other sections of H.R. 3525 shall take effect on January 1, 1984.

Chairman **Stark**. Mr. Huard.

## STATEMENT OF PAUL R. HUARD, VICE PRESIDENT OF TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. **Huard**. I am Paul Huard, vice president of taxation and fiscal policy for the National Association of Manufacturers.

Let me begin by applauding the sponsors of this legislation for a credible first effort at solving a longstanding and difficult problem. We fully agree that a legislative solution to this problem is greatly preferable to an administrative solution imposed by Treasury regulation. We are unable, however, to support H.R. 3525 as presently drafted. Our reasons for this are set forth below, along with recommendations for changes which, if implemented, would significantly improve the bill and make it possible for NAM to support it.

I would like to introduce my comments for the record and summarize my recommendations in the remaining time. I would like to address no-additional-cost services and employee discount together. Our overall view is that these two categories should be consolidated into a single category, and we think such a consolidtion would eliminate the unwarranted disparity between goods and services where in the former case only a 20-percent discount is available, but in the latter case in effect up to 100-percent discount may be available. Accordingly, both goods and services should be available tax-free under the following conditions:

One, they are available to employees and dependents on a nondiscriminatory basis. In this area we propose no change from the rules contained in H.R. 3525.

Two, the employer incurs no substantial incremental cost in providing the goods or services taking into account payments received from employees. This in effect permits tax-free discounts up to the amount of the employer's markup. This will also eliminate another disparity between goods and services relating to whether employee payments may be considered. We think that in determining whether the employer has in fact incurred incremental costs, employee payments should be taken into account in the case of both goods and services.

Three, the benefits in this category should be available to employees within a controlled corporate group. The limitation in H.R. 3525 relating to the trade or business in which the employee works is much too narrow.

Four, where the employer does incur substantial incremental costs in providing the benefits in this category, we believe the measure of taxable income to the employee should be the amount of such incremental increase rather than fair market value.

Turning to the working conditions fringes, in general we find this to be a reasonably defined category. We have two recommendations, however. First, parking should qualify as a working condition fringe without reference to any nondiscrimination test. Such a test does not apply to any other working conditions fringe, and we see no reason why parking should be singled out from all others and so treated. Second, we think that athletic and other recreational facilities should be treated as a working-conditions fringe without reference to any nondiscrimination test. Furthermore, regardless of how this is treated, we object strongly to the use of an alternative denial of employer deductions as the course of statutory device.

With regard to de minimis fringes, here again in general we think this is a desirable category and have only two recommendations, first that the de minimis exclusion should be expanded to cover retired and disabled employees as well as the spouses and children of all active, disabled, and retired employees. This is the same category of recipients who may receive the no-additional-cost services and employee discounts, and we see no reason why a narrower category of recipients would be justified in this case. Second, the de minimis exclusion should not include an annual aggregation rule. The key to whether a benefit qualifies under this exclusion should be the impracticality of accounting for it. If it is impractical they will account for it on a per incident basis and aggregation should not be required.

As to the effective date of this legislation and the extension of the existing moratorium, we have the following comments. January 1, 1984 is too early to put a new system of fringe benefits taxation in place. Employers need a reasonable amount of time to put new accounting and recordkeeping practices in effect. We therefore recommend that the effective date be the beginning of the first calendar year beginning at least 12 months after enactment of this bill, and that the current moratorium be extended until that time.

That concludes my comments. Thank you very much, Mr. Chairman.

[The prepared statement follows:]

## STATEMENT OF PAUL R. HUARD ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

I am Paul R. Huard, Vice President of Taxation and Fiscal Policy for the National Association of Manufacturers. On behalf of the Association's more than 13,000 members, who represent 80 percent of the nation's industrial output and 85 percent of its industrial workforce, I am pleased to have this opportunity to present our views on H.R. 3525, the "Permanent Tax Treatment of Fringe Benefits Act of 1983."

Let me begin by applauding the sponsors of this legislation for a very creditable first effort at solving a long-standing and difficult problem. We fully agree that a legislative solution to this problem is greatly preferable to an administrative solution imposed by Treasury regulation. We are unable, however, to support H.R. 3525 as presently drafted. Our reasons for this are set forth below, along with recommendations for changes which, if implemented, would significantly improve the bill and make it possible for NAM to support it.

### I. NO-ADDITIONAL-COST SERVICES; EMPLOYEE DISCOUNTS

H.R. 3525 would treat as a nontaxable employee fringe benefit the entire value of any service provided at no additional employer cost, provided such service (i) is available to the general public in the ordinary course of the employer's trade or business in which the employee works and (ii) is made available on a nondiscriminatory basis. In determining whether the service is provided at no additional employer cost, foregone revenues would be considered a cost and any payment made by the employee would be disregarded.

An employee discount of up to 20 percent (but not greater than the employer's profit margin) would likewise be treated as a nontaxable employee fringe benefit, provided such discount (i) relates to goods or services available to general public in the ordinary course of the employer's trade or business in which the employee works and (ii) is made available on a nondiscriminatory basis.

Our initial observation is that we fail to see any justification for using two separate categories with differing rules and think they should be combined in a single category with a uniform set of rules. Specifically, we recommend that an employer's provision of goods or services to employees be treated as a nontaxable fringe benefit if:

(1) The employer incurs no substantial incremental cost in providing the goods or services, taking into account any payments received from the employee;

(2) The goods or services begin provided are available to the public in the ordinary course of the employer's trade or business, with a controlled group of corporations (using a 50 percent stock ownership threshhold to determine control) being deemed for this purpose to be a single employer and any employee of any member of such group being deemed to be an employee of such deemed single employer; and

(3) The goods or services being provided are made available to employees (or to their spouses and children) on a nondiscriminatory basis, including as employees for this purpose those who have separated from the employer's service due to retirement or disability.

We would further recommend that, where requirements (2) and (3) above are satisfied, but requirement (1) is not because the employer does incure some measurable incremental cost in providing the goods or services, then the amount of taxable income to be imputed to the employee should be the lower of (i) the actual incremental cost increase to the employer, taking into account any payments received from the employee or (ii) the fair market value of the goods or services furnished less any payments made by the employee. In applying the foregoing rules, the method of conferring the benefit should be irrelevant. For instance, the same result should apply whether the employee buys a product at a 20 percent discount direct from the employer or pays full price at a store or dealership and then receives a 20 percent cash rebate from the employer.

We believe the adoption of the foregoing rules would eliminate the following problems inherent in the currently proposed rules for no-additional-cost services and employee discounts:

A. It would eliminate the disparity in the relative amount of benefit which can be conferred under the presently proposed separate categories. There is no demonstrated reason why, for example, an employee discount on a product may not exceed 20 percent whereas the discount on a no-additional-cost service is in effect 100 percent. We believe that the appropriate limitation on either type of benefit should be employer cost, so that the benefit is received tax-free so long as the employer incurs no incremental cost in providing the benefit or recovers its costs through payments received from employees. Thus, in the case of discounts, the amount of the discount would be tax-free up to the employer's markup and taxable only to the extent it exceeds such markup. Where services are concerned, the benefit would be tax-free if either there are no incremental employer costs or such costs are recovered through payments from employees.

B. For valuation purposes in cases where the employee is to be taxed, we think unrecovered employer cost is the fairest and most accurate measure. For one thing, this calculation will have to be made in any event to determine whether or not the benefit is tax-free. It is also a calculation which can be made with a relative degree of accuracy. The latter is frequenlty not the case with so-called "fair market value." What, for example, is the fair market value of a 50 percent employee discount, measured on the basis of retail value, when the article in question is available to the general public at anywhere from 60 percent to 100 percent of retail? In those unusual cases, however, where for some reason fair market value can be shown to be less than employer cost, then fairness dictates the use of such fair market value in determining the amount on which the employee is to be taxed.

C. Our proposed rules would eliminate the highly speculative issues involved in calculating foregone revenues from sales to the general public, particularly in the area of services. While there may be a few cases of limited availability services (e.g., airline seats) where such calculations may be feasible, in the vast majority of cases they will not. What revenues have been foregone where an employee of a telephone company is provided with free telephone service, or an employee of an amusement park with free admission passes? [Although we recommend against it, should some type of foregone revenues test be retained, it should apply only to that relatively narrow class of situations where, due to limited availability, some member of the general public actually was denied the service received by the employee.]

D. The proposed limitation of the current rules regarding the employee group within which no-additional-cost services and employee discounts may be made available would result in unfairness to employees and, in addition, would be a significant curtailment of existing practices. In many cases, the compensation and personnel policies of a large corporate employer are applied across divisional or subsidiary lines, and there seems to be little rational justification for limiting fringe benefit availability to narrowly defined sectors within a controlled corporate group. Where a corporation, for example, has separate divisions which manufacture appliances, diesel locomotives and military hardware, it makes precious little sense to provide that only employees of the appliance division can get discounts on appliances, only employees of the locomotive division can get discounts on locomotives, etc. The irrational variance in the meaningfulness of such discounts is apparent. Indeed, other than at the boundaries of a controlled employer group, it is hard to see why one arbitrary boundary is more appropriate than another. Why not, for instance, limit employees of the cosmetics department of a retail store to discounts on cosmetics rather than on any retail item sold by that store? Finally, it should be recalled that an employer may have substantial non-compensatory motivations for providing its goods or services to employees. One obvious consideration is that for purposes of prestige, name identification, etc. an employer may want to see its products used as widely and conspicuously as possible by its own employees.

## II. WORKING CONDITIONS FRINGES

H.R. 3525 would treat as a nontaxable employee fringe benefit the entire value of any property or service provided primarily for the purpose of facilitating the employee's work for the employer. Ordinarily, this exclusion would be available without regard to any nondiscrimination test. Generally, we find this category of exclusion from taxation to be a reasonable one, but rcommend that it be adopted with the following changes:

(1) Free or reduced cost parking should qualify as a working condition fringe but should not be singled out for special application of a nondiscrimination test. Such a test ignores the fact that (i) in many limited availability situations it is not possible to comply with the test and (ii) in many cases there are justifications for a classification (such as those employees having a need to leave and return to the office on multiple occasions during the day) which in effect might cover only highly compensated employees.

(2) Athletic and other recreational facilities used by employees (or their spouses or dependents) should be treated as tax-free working condition fringes available without regard to any nondiscrimination test. In the case of such facilities, NAM would strongly oppose, as we have done consistently in the past, use of the alternative denial of employer deductions as a coercive statutory device. We also believe that, in this case, no distinction should be made between provision of such facilities off-site

as opposed to on-site. Such comparability of treatment would recognize the fact that, especially in dense urban office locations, it may make more economic sense to pay a third party for use of nearby athletic or exercise facilities by employees than for the employer to self-construct such facilities.

### III. DE MINIMIS FRINGES

H.R. 3525 would treat as a nontaxable employee fringe benefit the value of any property or service where such value is so small that accounting for it would be unreasonable or administratively impractical. Generally, we find this category of exclusion from taxation to be a reasonable one, but recommend that it be adopted with the following changes:

(1) The exclusion should be expanded to cover retired and disabled employees as well as the spouses and children of all active, retired and disabled employees. As a practical matter, if accounting for a benefit is unreasonable or administratively impractical, it will be so whether or not the group is so expanded, and there is no logic for permitting no-additional-cost services and employee discounts to such an expanded group while at the same time foreclosing receipt of de minimis fringes within that group. Such an expansion would also be more consistent with the technical explanation offered in connection with H.R. 3525, which indicates that occasional company cocktail parties or picnics and traditional Christmas gifts are contemplated to be de minimis fringes. Company parties and picnics frequently are attended by family members and often may include retired or disabled former employees. Consumption of the traditional Christmas ham likewise is not typically limited to the employee who received it.

(2) In determining whether a benefit is so small that accounting for it is not worthwhile, no aggregation rule should be applied. Here again, this change would conform the rule in the bill to the example offered in the technical explanation, which indicates that reduced cost cafeterias would be considered a de minimis fringe, even though such cafeterias are obviously candidates for application of an annual aggregation rule. The key consideration should be impracticality determined on a per incident rather than an aggregate basis.

### IV. OTHER COMMENTS

As regards the effective date of H.R. 3525, we believe January 1, 1984 is premature. Under optimum conditions, this bill is not likely to be passed, if at all, much before the end of 1983. Given the requirements for adequate lead time for employers to implement such accounting and recordkeeping changes as might be required to comply with a new statutory scheme of fringe benefits taxation, the effective date should be no sooner than the first calendar year beginning more than 12 months after enactment. What this means in practice is that the existing legislative moratorium on changes in fringe benefit taxation by the Treasury Department should be extended until at least 1985.

Finally, although it is not a significant feature of H.R. 3525, we would question the policy justification for removing those nontaxable fringe benefits defined within the bill from the ambit of cafeteria plan. There has been no convincing articulation of reasons why certain nontaxable fringes may be included in cafeteria plans while others may not.

### V. CONCLUSION

We again congratulate the sponsors of H.R. 3525 for recognizing the need for a legislative solution in this important area. Nevertheless, NAM must oppose the bill in its present form, and therefore we urge this Subcommittee to adopt the recommendations set forth herein, which would enable us to change our position to one of support.

Chairman STARK. Thank you very much. It seems to me that you are urging that we do away with the nondiscrimination requirement—you are really just for working condition fringes. Don't you really erode the purpose of that requirement?

Mr. HUARD. Mr. Chairman, if in fact it is a working condition fringe and it is related to the performance of the employee's tasks, we don't see any reason why there should be a nondiscrimination test. For instance, if you have an employee—an executive—who has to go out frequently during the course of the day on business appointments, you are saying it is OK if we provide him a chauffeured limousine, but if we provide him free parking so he can go in and out in his own car, then it is taxable unless we give everybody in the business free parking. That doesn't make a great deal of sense to me.

Chairman **Stark**. No; but let me put it this way. I guess you could say it another way. If you were going to send people on errands, you have no quarrel with sending the vice president in a chauffered limousine, but then it seems when you send the stock person, you might pay their cab or subway fare.

Mr. **Huard**. That is reasonable.

Chairman **Stark**. I guess what we are trying to say is that somebody who needs to get someplace will be provided transportation. That to me is not discriminatory. It could be a bigger or smaller car, I suppose, depending on their rank and importance, and basically I don't think we are kidding anybody. We are attempting to find that benefit which is a pure perk and has no relationship to producing any income—and that ought to be taxed.

And so that one way to do that is if it is important to the company, they will provide it to everybody. Where we find the most abuses in all kinds of plants is it goes only to a very few highly paid, highly salaried employees. There are consulting companies who make a fortune telling you how to do that, how to dump all your retirement perks to the high-paid individuals.

We went through that in Mr. Rangel's subcommittee last year, and it is perceived by some as not being fair.

Mr. **Huard**. Well, if I could be sure that the Treasury would interpret what constitutes a valid reason to give somebody free parking as reasonably as you do, I might withdraw my objection.

Chairman **Stark**. It seems to me the only place that you might question parking is like in downtown Manhattan, where there isn't any, and you are talking about the cost of a parking slot exceeding the cost of an apartment in other areas of the country. These are very distorted costs. I am even seeing now that it is a fringe benefit that juniors and seniors in high school expect on suburban campuses.

I think the question of parking becomes critical where it is in short supply. Then it is a taxable fringe.

Mr. **Fay**. Our comments on antidiscrimination weren't addressed to the appropriateness of that requirement for the first two categories of the bill. It was merely that we question the need to have for this one working condition fringe and no other a nondiscrimination test.

If you review the Congressional Record explaining this bill, it states that in determining what is a proper classification, if a classification includes just the highly paid, then that would not be a proper classification. So at least the legislative history, as it stands right now, would not support the kind of flexibility that you were suggesting, although of course it could be changed.

Also, let's analyze the example given in the Congressional Record of a working condition fringe which was security protection to Americans working abroad. Now, there are exceptions to every rule, but I think the record will show that the people most threatened, most likely to be subject to terrorist attack, are the high embassy officials, ambassadors, et cetera. By its very nature, therefore, this kind of protection is discriminatory, and we are saying it really doesn't make sense if you can demonstrate that it is a true working condition fringe to add a nondiscrimination test. If a benefit meets the rather strict standards of the working condition fringe, that should be it.

Chairman **Stark**. I have always felt if the CIA would stop killing people over there covertly, they would stop shooting back at us, and that would be a cheaper way to get at this.

Mr. **Koplan**. I would like to comment on the nondiscrimination provision. I think it is of critical significance to this bill. It is a very important provision, and I don't think it is limited to parking. As I recall, the nondiscrimination provisions apply to the employee discounts, they apply to tuition, they apply to the no-additional-cost factor, I think to about everything in the bill with the exception possibly of the provision relating to recreational facilities. We strongly support the nondiscrimination provisions in the bill.

Mr. **Fay**. We agree that the nondiscrimination provisions apply to both categories, but our comments are addressed to parking, which is in the bill's working condition fringe category.

Chairman **Stark**. In other words, you have a problem with making parking nondiscriminatory?

Mr. **Fay**. We have a problem of imposing a standard on that working condition fringe which others do not have to meet.

Chairman **Stark**. How would you feel if we just imposed the nondiscriminatory parking on Members of Congress?

Mr. **Fay**. I think that would be highly discriminatory.

Chairman **Stark**. I think it might be highly desirable from a political standpoint, if no other reason.

Mr. **Huard**. I would like to clarify our position on the nondiscrimination test. We have no objection to the application of this test to the first categories. I think—if I can try and further explain my comments—what we are trying to get at is a problem which I see in the legislative history which says that if you have a classification which is nonetheless reasonable—say all employees have to go in and out during the day on business calls, and the effect of that is it only covers highly compensated employees, you are going to flunk the test and that is what we object to.

Chairman **Stark**. I agree that is difficult, and I think that becomes a judgment call in a lot of areas. I gather that is something that we all have to face regardless of the outcome of this bill. We never know for sure what kind of regulations the Service is going to come up with nor how they approach present practices as people seek to justly find ways to minimize their tax bite.

One other question that was raised is the abuses in the recreational facility area. Aside from the fact that you must observe that there are a few ski slopes and golf courses which are maintained only for officers and not for enlisted people around the world at great cost to the American taxpayer with a minimum increase in our national security, the issue here really is that if it does represent compensation, how should it be recognized.

The issue isn't really that it is not abused or not abused yet; the issue is if you are going to look at this, then you have to figure out how do you treat it for tax purposes. I personally want to thank you all for the trouble you went through to prepare your testimony.

Do other members of the subcommittee have questions?

Mr. DUNCAN. I have no questions. I want to thank the panel.

Chairman STARK. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

It appears to me that if an employer provides parking, then the parking itself should not be a fringe benefit. I understand the point that you are making, Mr. Fay. If you have 400 employees and you may have a need for 10 of them to travel during the day, then it should not be necessarily required that you afford 400 parking spaces in order to get the tax deduction for those that may use an automobile during the course of business.

Mr. Koplan, is it your position that if you permit tax-free treatment for a parking space, you must do it for all employees?

Mr. KOPLAN. It should be provided on a nondiscriminatory basis, yes. One way to do that is to provide it on the basis of seniority, for example.

Mr. JENKINS. Is that nondiscriminatory?

Mr. KOPLAN. Well, if it is available to all employees on a—if you have got 400 employees and 400 spaces, of course, you have no problem, but if you have got 400 spaces and 500 employees and you don't have parking to accommodate everyone, if it were provided on a nondiscriminatory basis, for example, on the basis of seniority——

Chairman STARK. If the gentleman would yield, I think when we used discriminatory in the bill, we only were referring to salary level. I think that is consistent throughout here, that these fringes would not discriminate on a basis of salary level.

If you selected limited amounts of parking by lottery or distance from work it might be a reasonble classification, so long as it did not favor the highest paid people.

Mr. JENKINS. What if you had four parking spaces and 400 people, would you draw lots?

Chairman STARK. I would say anything except just building those for the four highest paid would be nondiscriminatory. You could draw lots by seniority, health, a whole host of considerations.

Mr. JENKINS. It would appear to me that there may be times when certain employees would have to use an automobile. Would those instances, if they were covered in the bill, open the door for denying tax deductible treatment if all people were not offered spaces?

Chairman STARK. Certainly not. In my opinion, that was not the intent of the bill. I think the issue throughout the language of the bill, when we are talking about discriminatory, would be strictly related to salary not business purposes.

Mr. FAY. I would like to make the point that the working condition fringe is not without its own standards and limitations. For a fringe to qualify as a working condition fringe, the fringe must be provided to the employee primarily for the purpose of facilitating the employee's work and substantially all off the use of the property or services must reasonably be expected to occur in connection with the employee's work.

This isn't just something that is given free of restriction. In fact, the alternatives suggested, seniority or lottery, violate these restrictions of the working condition fringe. If you do it by lottery, there is no proof that the parking has any relation to the employee's work; it is just passed out like Christmas turkeys. All we are saying is if it doesn't make sense to create a nondiscrimination test for working conditions fringe generally, then what is the rationale for it in the case of parking? It introduces an inappropriate concept, one that is violative of the conceptual logic of that category itself.

Mr. **Koplan**. Let me just mention, I am looking at the explanation of the provision and the illustration at the time of the introduction of the bill was that an employer could establish a classification that is based on certain appropriate factors, such as seniority or job description, provided that the effect of the classification is nondiscriminatory, and then the example given is that if an employer makes free or reduced-cost parking available to all its employees on the basis of seniority and if those employees who have parking spaces constitute a fair cross-section of all employees, then the fair market value of the parking space as provided would be excluded under the bill.

We have no problem with the description of the provision as outlined by the sponsors.

Mr. **Jenkins**. But if it was not a fair cross-section, but at the same time you did provide 25 percent of the hourly people parking spaces, would you take the position that they ought to pay income tax?

Mr. **Koplan**. We would agree with the sponsors that if the effect of the way it is constructed is to provide free or reduced-cost parking only to highly compensated employees that it should not be excluded, and that is the stated intent.

Mr. **Jenkins**. What if it included highly paid salaried people and a few hourly people? Do you think the hourly people ought to have to pay?

Mr. **Koplan**. If the main thrust of the provision is to cover highly compensated employees, then I don't think it would qualify.

Mr. **Jenkins**. The point I was making is, say an employer had 200 parking spaces, 1,000 employees, and he gave 10 of them to his salaried people, if that is what the total was, and the other 190 to hourly employees based upon seniority. Do you think those 190 ought to have to pay because it is not a cross-section?

Mr. **Koplan**. No.

Mr. **Jenkins**. You would exempt them? Or someone that managed but just selected 190 of the hourly people?

Mr. **Koplan**. I think you would have to look at the system for giving out the spaces, and it would appear to be constructed in a nondiscriminatory manner to give everybody a shot at a spot, depending on how long they had worked for a company. I don't think that that should be taxed.

Mr. **Jenkins**. I think my time is up. Thank you.

Chairman **Stark**. Any other questions?

Mr. **Flippo**. Mr. Chairman, I think that Mr. Fay recommended that the rules for receipt of tax-free services and the 20-percent discounts be combined. What I am interested in, are you primarily concerned with meeting the revenue test with regard to the free services or are you concerned with the calculation of the markup rules?

Mr. **Fay**. The main concern with the discount category that I mentioned was the calculation of the 20-percent discount. Initial comments we received from our members is that there is not one single price, there is not one single market, and that we are essentially talking about a profit margin tests, which would be at the least very difficult accounting for.

And, therefore, we recommend—and I grant you that it is somewhat arbitrary, but there is an arbitrary quality to all this legislation—is just to say that a 20-percent discount from the selling price is all right and let it go at that.

Mr. **Flippo**. If you think of any examples that you could furnish us, it would be helpful for the record.

Mr. **Koplan**. I look forward to working with all of you.

Chairman **Stark**. We thank the panel.

The next panel is Mr. William Turnbull, president of the National Automobile Dealers Association; and Mr. George Erb, Erb & Co., Lake Success, N.Y.

Mr. Turnbull, would you proceed.

## STATEMENT OF WILLIAM C. TURNBULL, PRESIDENT, NATIONAL AUTOMOBILE DEALERS ASSOCIATION, ACCOMPANIED BY FRANK E. McCARTHY, EXECUTIVE VICE PRESIDENT

Mr. **Turnbull**. Thank you, Mr. Chairman, and also members of your committee. My name is William C. Turnbull. I am president of the National Automobile Dealers Association.

Chairman **Stark**. Mr. Turnbull, if I could interrupt for a minute. These microphones don't work unless you practically swallow them. If you could pull that a little closer, I think the audience could hear you better.

Mr. **Turnbull**. Thank you.

Mr. Chairman, and members of your committee, my name is William C. Turnbull. I am president of the National Automobile Dealers Association. I am a dealer in automobiles and trucks in West Virginia and also in South Carolina.

With me on my right is Frank McCarthy, who is executive vice president of NADA.

On behalf of the association of approximately 18,400 members, we would like to express our appreciation to you for the opportunity to testify before you today. We are primarily interested in the provisions added by section 132(g)(3) which relate to the use of a demonstrator automobile or truck by a sales person employed by an automobile or truck dealer. At the outset, Mr. Chairman, let me indicate to you and to Mr. Conable that we think you have structured these provisions in a responsible and realistic manner, and we support your efforts. For a number of years there has been a good deal of debate regarding the proper tax treatment of demonstrators for automobile and truck sales persons.

However, both dealers and sales persons have consistently taken the position that the use of a demonstrator properly should not be treated as a type of benefit which constitutes income to the sales person under the Internal Revenue Code. The use of demonstrator vehicles has evolved over the years as a necessity, you may say it is necessary in the business of merchandising new cars and trucks.

A new car or truck, unlike some consumer goods, is a very expensive item and not purchased everyday. Therefore, many buyers want to drive the vehicle prior to making the final decision to buy. There are several ways that the retail automobile dealer may accommodate this understandable demand by the consumer, but from a business point of view, the current practice of using demonstrators and demonstrator vehicles by the sales person makes the most sense.

We could, for example, let the buyer look over our entire inventory and test drive the vehicle of his choice for color, body style and other ways. However, this would mean putting mileage on many of the cars in the dealer's inventory, which consequently would make the cars less attractive to the next buyer who may want to look at them. That simply doesn't make any sense to us.

What dealers have chosen to do in lieu of this practice is to provide their sales persons with representative samples of the vehicles they sell. This allows the buyer to have a vehicle to drive to check the options, the body style and at the same time allows the dealer to maintain an inventory that is basically mileage free. As far as we can determine, the great majority, if not all dealers, have agreements with their sales persons prior to assigning them the demonstration vehicle.

It should be noted, however, that vehicles that are designated as demonstrators continue to be a part of the dealer's inventory and are for sale at any time. Consequently, the common thread running through these agreements are provisions which relate to the immediate merchandisability of these cars and trucks and prohibitions on activities by the sales persons which would depreciate their value.

This being the case, I think you can find in the text a number of various requirements we have requiring that the vehicle be kept clean at all times, and that it be available to other sales persons. In addition, it is important to note that the dealer makes the choice of which car shall be used as demonstrators. The sales person does not have that choice.

Even more important, the sales person cannot refuse the use of the demonstrator. It is such a necessary incident to the business of selling new cars and trucks that the sales person must use a demonstrator.

Since you have got my red light on here, I will have to be a little careful.

Chairman STARK. Just orange light.

Mr. TURNBULL. As far as H.R. 3525, which deals with the question of demonstrators, we are basically in accord with your position. We fully support the qualified employee discount provision of H.R. 3525.

In conclusion, we are in full agreement with the basic concepts contained in the provisions relating to the use of a demonstrator automobile by a sales person as well as the provisions relating to the qualified employee discounts. You have the text that we have briefly gone through this morning. Should there be any questions, we would be happy to answer them for you at this time.

[The prepared statement follows:]

### STATEMENT OF WILLIAM C. TURNBULL, PRESIDENT, NATIONAL AUTOMOBILE DEALERS ASSOCIATION

Mr. Chairman and members of the committee, my name is William C. Turnbull and I am president of the National Automobile Dealers Association. I am also a Buick and Suburu dealer, as well as a GMC and International Harvester medium and heavy-duty truck dealer from Huntington, West Virginia. In addition I have a Chevrolet and Oldsmobile dealership in South Carolina. With me today is Frank E. McCarthy, who is the executive vice president of NADA. On behalf of the association's approximately 18,400 franchised new car and truck dealers. I would like to express our appreciation for the opportunity to testify before you today on H.R. 3525, the Permanent Tax Treatment of Fringe Benefits Act of 1983.

While the bill addresses a number of areas with respect to fringe benefits, we are primarily interested in the provisions added by section 132(g)(3) which relate to the use of a demonstrator automobile or truck by a salesperson employed by an automobile dealership. The bulk of our testimony will center on this provision, but we would also like to comment briefly on the provisions relating to "qualified employee discount." At the outset, Mr. Chairman, let me indicate to you and to Mr. Conable that we think you have structured these provisions in a responsible and realistic manner and we support your efforts.

For a number of years there has been a good deal of debate regarding the proper tax treatment of the use of demonstrators by automobile and truck salespersons. The basic question, of course, has been whether the use of a demonstration vehicle by an automobile salesperson constituted the type of economic benefit which should be included in the gross income of that salesperson and, therefore, subject to taxation. Collateral questions regarding the proper valuation of that alleged benefit and the responsibility of the dealer to withhold tax on the asserted value of the benefit have also been subjects of this debate.

Both dealers and their salespersons have consistently taken the position that the use of a demonstrator properly should not be treated as the type of benefit which constitutes income to the salesperson under the Internal Revenue Code. The use of demonstration vehicles has evolved over the years as a necessary mechanism in the business of merchandising new cars and trucks. A new car or truck, unlike most consumer goods is a very expensive item which most prospective buyers want to try before making a final purchasing decision. There are several ways that a retail automobile dealer may accommodate this understandable demand by the consumer, but from a business point of view, the current practice of providing demonstration vehicles to salespersons makes the most sense.

For example, the dealer could allow the prospective buyer to look over his entire inventory and test drive the car of his choice in regard to style, color, options, etc. However, this would involve putting mileage on many of the cars in the dealer's inventory which, consequently would make these cars less attractive to other prospective buyers. That simply doesn't make any sense. What dealers have chosen to do in lieu of this practice is to provide their salespersons with representative samples of the vehicles they sell. This allows prospective buyers to have the opportunity to drive the type of vehicle the dealer sells while at the same time allowing the dealer to maintain an inventory that is basically mileage free.

As far as we can determine, the great majority, if not all, dealers enter into agreements with their salespersons prior to assigning them a demonstration vehicle. Inasmuch as franchised new car and truck dealers are truly independent businesspersons, there is no uniform agreement that is used by all and the provisions contained in these agreements may vary. It should be noted, however, that the vehicles that are designated as demonstrators continue to be a part of the dealer's inventory and are for sale at any time. Consequently, the common thread running through these agreements are provisions which relate to the immediate merchantability of these cars and prohibitions on activities by the salespersons which would depreciate their value. That being the case, provisions which are likely to be contained in a salesperson's demonstrator agreement would:

(*a*) Require that the car be kept clean at all times;

(*b*) Prohibit the salesperson from storing personal possessions in the car;

(*c*) Require that the salesperson be prepared to show the car for sale at any time;

(*d*) Prohibit the salesperson from using the car for vacation trips or for other activities that would put excessive miles on the car and thereby depreciate its value.

Other provisions relating to insurance, gas, financial responsibility in the case of an accident, etc. may also be addressed in these agreements. In addition, it is important to note that the dealer makes the choice of which cars will be used as demonstrators. The salesperson does not have the choice as to model, color, options, etc. Even more important, the salesperson cannot refuse the use of a demonstrator. It is such a necessary incident of the business of selling new cars and trucks that the salesperson must use a demonstrator.

In short, it has long been our position that any personal benefit to a salesperson from the use of a demonstrator is merely collateral to the real purpose of using demonstrators and should, therefore, have no tax consequences.

The provisions of H.R. 3525 which deal with the questions of the use of demonstrators by automobile and truck salespersons are in basic accord with our position on this issue. Consequently, we have only a few suggestions. We have noted that the term "sales area" as used in this provision is not a defined term. We think that this is proper since a "sales area" may vary depending on the location of a particular dealership. However, we think that unnecessary confusion might be avoided if the committee report on this bill makes it clear that the term "sales area" relates to the geographical area in which the dealer sells cars and not merely the premises of the dealership.

We have also noted that the term "substantial restrictions on personal use" is not a defined term. Again, we think that this is proper since it may vary depending on the particular circumstances involved. However, once again, in order to minimize confusion in the future we would hope that the committee report would include the type of explanation which was included in the introductory remarks on this bill regarding what would be considered "substantial". In this context we might add that the wording of the suggested restriction relating to the limit in the number of miles which the salesperson may drive the vehicle might be altered to take into account the circumstances of a broad sales area, rural location, etc. We believe that this type of retriction can be expressed in terms other than in a specific limit on miles driven.

We may have other suggestions of this type as we review the many circumstances that confront individual dealers and their salespersons. We hope that we will be able to address these matters with the committee should they arise and offer suggestions in dealing with them.

I would like to briefly address the provisions of the bill relating to qualified employee discounts. Many dealers allow their employees to purchase new cars and trucks at a discount. In addition, many dealers allow an employee discount on parts and service. The discount on the purchase of a new vehicle varies from dealer to dealer. The same is true of employee discounts on parts and service. We feel that this type of benefits helps solidify employee-employer relations and helps demonstrate loyalty to the dealer's product. We strongly fee that the employee should not be taxed on the receipt of this type of benefit. Therefore, we fully support the "qualified employee discount" provisions of H.R. 3525. In case of automobile dealer and their employees we are unaware of cases in which such discounts exceed "20 percent of the price at which the property or services are being offered by the employer to customers who are not employees."

In conclusion, we are in full agreement with the basic concepts contained in the provisions relating to the use of a demonstrator by an automobile salesperson, as well as in the provisions relating to qualified employee discounts, and we intend to support them. Once again we appreciate the opportunity to testify before you today and we will be happy to try to answer any questions that you might have.

Chairman **Stark**. Thank you. Mr. Erb.

## STATEMENT OF GEORGE L. ERB, MANAGING PARTNER, ERB & CO., LAKE SUCCESS, N.Y.

Mr. **Erb**. I submitted a prepared statement, and I am not going to take up the committee's time by reading through that same statement.

I would like, however, to make a couple of points. Mr. Walker of the AICPA mentioned the fact that this provision for use of cars by salespersons in an automobile dealership should be broadened to cover other qualified employees and in most automobile dealerships there is a need for managers and even the owner to loan cars to customers and to make demonstrations and I believe these individuals should be included in the list of those employees who would be covered under the working condition fringe benefits.

I have also submitted a formula for determining whether the use of a car by a salesman or other employee should be nontaxable even though there is some personal use.

I suggested a formula of mileage be used to determine whether the automobile employee is actually using the car mostly for business purposes or for personal use. If it is for personal use, we would propose charging for excessive personal use.

In many dealerships, you will find an employee has two cars, one for himself and one for the wife, which means the second car, of course, would be a personal car and would be subject to taxation as such.

In determining the 20-percent employee discount and in determining what is fair market value of use of an automobile, again you have a problem because the same car at the same dealership can be sold at many different prices depending on market conditions at the time and to whom it is sold.

Again, we aline ourselves with those who say that the 20-percent employee discount figure should be dropped because it is very difficult in the case of an automobile to determine the base to which you apply this 20 percent.

Also if we were to apply a cap to all fringe benefits, we again, I think, have kind of a problem when you have working condition fringes added to other types of fringes. The use of a car by a car salesman would amount to a sizable amount of money that might exclude him from other fringe benefits. This automobile usage fringe is necessary for the salesman in the performance of his job.

We think if there is a cap, the cap should be on one type fringe rather than lump all the fringes together as on a total.

We have attached one other item to our papers. You will find a series of invoices that we gathered from one dealership. The Treasury brought up the idea that the use of demonstrators by the salesmen results in costs to the dealer. Our position is that there is little, if any, cost to the dealer.

We have submitted a series of invoices showing the original cost of a car when it is put in demonstration and the sales price when the car has been sold. These invoices would indicate that there is surely no chance of a loss by the dealer on the sale of these cars.

We agree essentially with what H.R. 3525 does. Our business is working with automobile dealers exclusively on a national basis and if we can furnish the committee any further information, we would be happy to do so.

Thank you.

Mr. JENKINS. Thank you very much for your testimony.

[The material referred to follows:]

Oj 87

**ERB & COMPANY**
*Accountants • Auditors*
2001 MARCUS AVENUE
LAKE SUCCESS, NY 11042
TELEPHONE: 516-354-2331

August 1, 1983

John J. Salmon, Esq., Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 3525

Dear Mr. Salmon:

Enclosed is an outline of the material we plan to cover regarding fringe benefits at the August 1, 1983 hearing. We presume actual testimony will be recorded by a stenographer.

Very truly yours,

George L Erb

GLE:d
George L. Erb

Encl.

## FRINGE BENEFITS

Baseball, hot dogs, and apple pie are all very American, but probably nothing is more American than the desire to get something for nothing. And, as a result of this "Americanism", a primary consideration in the employment market is the value of company furnished benefits, particularly those that are non-taxable.

Most of us probably felt pretty comfortable with the provisions of Regulation 1.61.14 as it used to read: .....the use is non-taxable if it does not result in a significant cost to the employer.... Our business deals with the retail automobile dealer and, in some instances, with the manufacturer through corporate branches. We point out that one of every six Americans are employed by the automobile industry, making that industry the country's largest employer.

One of the principal issues to be resolved here today is the use of a company owned vehicle by a salesperson employed by an automobile dealership. With the permission of this Committee, we would request the statement of the issue to read: Use of an automobile dealership owned vehicle by salespeople and other employees authorized to use such vehicles.

First, we should probably distinguish between use by the employee of a company other than an automobile dealership and use by a dealership employee. As an example, let us take the case of Company X, a beverage distributor. Company X employs Y, a salesman whose duties consist of contacting, on a weekly basis, all the customers of X for the purpose of taking orders. Company X provides Y with a car. Y uses this car to visit all of his customers, but the car is garaged at Y's home and, during non-business hours, is available for his personal use. The Company pays for all maintenance, and at the end of each model year, the car is turned in for a current model. The car is registered in the name of Company X and the company pays for the insurance. There is no question here but that personal use is involved and that Y has taxable income. Also, there is a substantial cost to Company X, measured by the cost of the car less the amount allowed as a trade at the end of a year's use. The income amount to Y might be this trade difference, plus all maintenance charges, multiplied by a percentage derived by dividing personal miles driven by total miles driven.

The case of the automobile company employee is different. At the beginning of a model year, a salesperson is assigned a company demonstrator. This car is not registered at the State Motor Vehicle Bureau, but is assigned a set of dealer plates. Insurance is provided under the Dealer's blanket liability policy. Maintenance is provided in the dealer's shop under the vehicle warranty agreement, and the car is floor-planned along with the dealers' other new cars and demonstrators. There are some pretty uniform rules covering the use of a demonstrator:

(1) The car must be at the dealership during all business hours.

(2) The car must be maintained in saleable condition at all times.

(3) A salesperson's performance is measured, not only by how many cars he may sell, but also by how many demonstrations he makes.

(4) A demonstration need not be made by the car assigned to one, but may be made using any demonstrator that is most suitable to the prospective purchaser.

(5) Mileage is strictly controlled and most dealerships require that demonstrators be returned to inventory after about 5,000 miles of use.

(6) The demonstrator may be driven to the salesperson's home at night and back to the dealership in the morning. Frequently, however, the salesperson calls on a prospect on the way home or on the way to work or runs some company errands going or coming.

(7) The car assigned to a dealership employee is subject to sale at any time and is not treated as being for the exclusive use of any individual for any given period of time. The average sales person will probably be assigned three different demonstrators during the course of a year.

The really important factor here, however, is that these demonstrators are sold by the dealer at almost the same amount of profit as if the car was new with zero mileage. We enclose a few demonstrator wash-out sheets that were picked out at random by one of our dealers. The circled amount at the right of the sheet indicates the gross profit on each car. Certainly, these profits indicate that there is no cost to the employer in furnishing the cars to the employee. Also, a demonstrator is a necessary tool to the automobile salesperson. Additionally, there is advertising exposure in having potential customers see these demonstrators in the community.

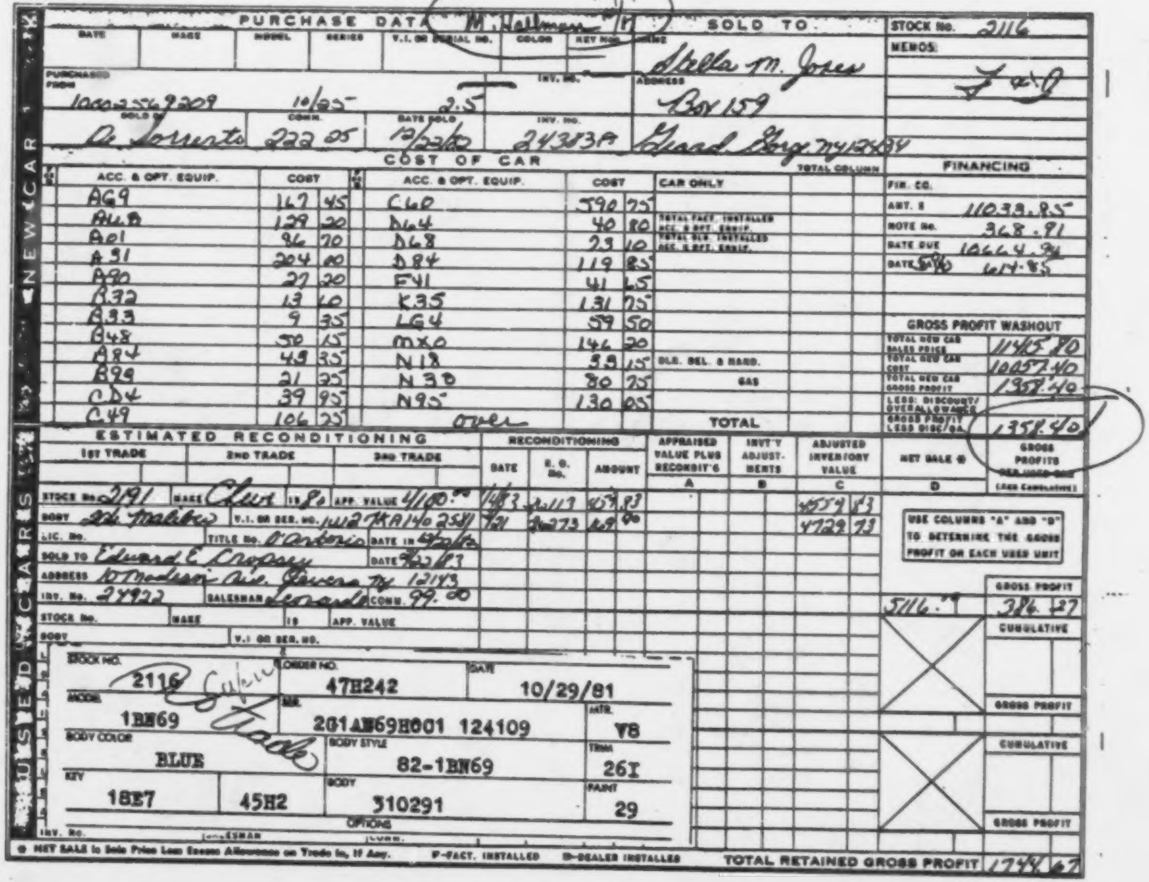
We believe that all of the benefits provided by former regulation 1.61-14 should be continued if there is no cost to the employer and personal use is less than 25% of the total miles driven. This same measure of taxability should be applied to demonstrators assigned to dealership personnel other than salespeople. Generally, the dealer himself will have a demonstrator, as will department managers. Just as in the case of salespeople, these cars are used for demonstration, for running company errands, and for loaning to customers.

Most salespeople and company managers own one or more cars, in addition to the demonstrator assigned. These personally owned cars are used as family cars and for personal trips.

We urge this Committee to consider demonstrators assigned to salespeople and department heads as non-taxable, employment connected benefits as long as the personal mileage driven constitutes less than 25% of the total mileage driven. Where personal mileage exceeds 25% of total use, then all personal mileage would be taxable at 20 cents per mile.

# NEW & USED CAR RECORD

FORM SA-284-6 (4-71)
RING BINDER SPR-710
DELUXE BINDER SPD-710
STANDARD BINDER SPS-710
THE REYNOLDS & REYNOLDS CO.
CELINA, O. - DALLAS, LOS ANGELES
LITHO IN U.S.A.



**NEW CAR**

**PURCHASE DATA**

| DATE | MAKE | MODEL | SERIES | V.I. OR SERIAL NO. | COLOR | KEY NO. |
|---|---|---|---|---|---|---|
| | | | | | | |

M. Hellman 10/81

PURCHASED FROM: 1000-2569209 10/25 2.5

INV. NO.:

SOLD BY: A. Sorrento

COMM.: 222 05

DATE SOLD: 12/22/82

INV. NO.: 24383A

**SOLD TO**

NAME: Stella M. Jones
ADDRESS: Box 159
Grand Gorge NY 12434

STOCK No. 2116

MEMOS:
F & G

**COST OF CAR**

| ACC. & OPT. EQUIP. | COST | | ACC. & OPT. EQUIP. | COST | |
|---|---|---|---|---|---|
| AG9 | 167 | 45 | C60 | 590 | 75 |
| AU8 | 129 | 20 | D64 | 40 | 80 |
| A01 | 96 | 70 | D68 | 23 | 10 |
| A91 | 204 | 00 | D84 | 119 | 85 |
| A90 | 27 | 20 | F41 | 41 | 65 |
| B32 | 13 | 60 | K35 | 131 | 75 |
| B33 | 9 | 35 | LG4 | 59 | 50 |
| B48 | 50 | 15 | MXO | 146 | 20 |
| B84 | 49 | 35 | N18 | 39 | 15 |
| B99 | 21 | 25 | N30 | 80 | 25 |
| CD4 | 39 | 95 | N95 | 130 | 05 |
| C49 | 106 | 25 | over | | |

CAR ONLY
TOTAL FACT. INSTALLED ACC. & OPT. EQUIP.
TOTAL DLR. INSTALLED ACC. & OPT. EQUIP.
DLR. DEL. & HAND.
GAS
TOTAL
TOTAL COLUMN

**FINANCING**

FIN. CO.
AMT. $ 11038.85
NOTE No. 368.91
DATE DUE 10664.94
DATE 5/96 614.85

**GROSS PROFIT WASHOUT**

| | |
|---|---|
| TOTAL NEW CAR SALES PRICE | 11415.80 |
| TOTAL NEW CAR COST | 10057.40 |
| TOTAL NEW CAR GROSS PROFIT | 1358.40 |
| LESS: DISCOUNT/OVERALLOWANCE | |
| GROSS PROFIT LESS DISC/OA | 1358.40 |

**USED CARS**

**ESTIMATED RECONDITIONING**

1ST TRADE | 2ND TRADE | 3RD TRADE

STOCK No. 2191 MAKE Chev. 19 80 APP. VALUE 4100.00
BODY 2dr Malibu V.I. OR SER. NO. 1W27KA140258
LIC. No. TITLE No. D'Antonio DATE IN 12/22/82
SOLD TO Edward E. Cropsey DATE 9/22/83
ADDRESS 10 Madison Ave. Ravena NY 12143
INV. No. 24922 SALESMAN Leonardo COMM. 99.00
STOCK No. MAKE 19 APP. VALUE
BODY V.I. OR SER. NO.

| RECONDITIONING DATE | R. O. No. | AMOUNT | | APPRAISED VALUE PLUS RECONDIT'G A | INV'T'Y ADJUST-MENTS B | ADJUSTED INVENTORY VALUE C | | NET SALE ● D | GROSS PROFITS PER USED CAR (AND CUMULATIVE) |
|---|---|---|---|---|---|---|---|---|---|
| 1/4/83 | 20113 | 459 | 83 | | | 4559 | 83 | | |
| 9/21 | 20273 | 169 | 90 | | | 4729 | 73 | | |
| | | | | | | | | 5116.00 | 386.27 |

USE COLUMNS "A" AND "D" TO DETERMINE THE GROSS PROFIT ON EACH USED UNIT

GROSS PROFIT
CUMULATIVE
GROSS PROFIT
CUMULATIVE
GROSS PROFIT

| STOCK NO. | ORDER NO. | DATE | |
|---|---|---|---|
| 2116 | 47H242 | 10/29/81 | |
| MODEL | SER. | | MTR. |
| 1BN69 | 2G1AN69H001 124109 | | V8 |
| BODY COLOR | BODY STYLE | | TRIM |
| BLUE | 82-1BN69 | | 26I |
| KEY | | BODY | PAINT |
| 18E7 | 45H2 | 310291 | 29 |

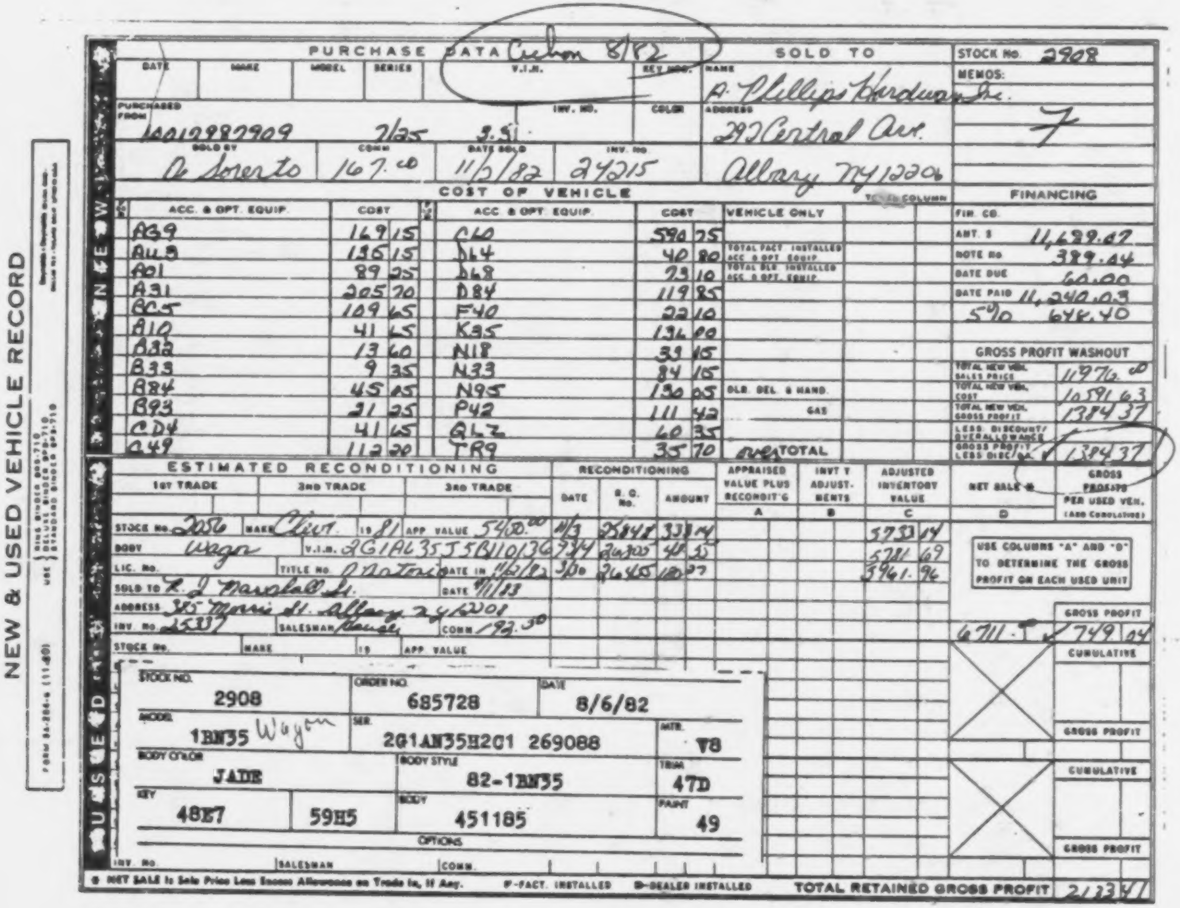
OPTIONS

Cutlass Std Trade

INV. No. SALESMAN COMM.

● NET SALE is Sale Price Less Excess Allowance on Trade In, If Any. F-FACT. INSTALLED D-DEALER INSTALLED

TOTAL RETAINED GROSS PROFIT 1744.67



# NEW & USED VEHICLE RECORD

FORM 84-204-6 (11-80) USE RING BINDER 909-710 / DELUXE BINDER 9P9-710 / STANDARD BINDER 9P8-710

**NEW**

PURCHASE DATA Cushon 8/82

| DATE | MAKE | MODEL | SERIES | V.I.N. | KEY NO. |
|---|---|---|---|---|---|
| | | | | | |

| PURCHASED FROM | | | INV. NO. | COLOR |
|---|---|---|---|---|
| 1A0199287909 | 7/25 | 3.51 | | |

| SOLD BY | COMM | DATE SOLD | INV. NO |
|---|---|---|---|
| A Sorento | 167.00 | 11/2/82 | 24215 |

SOLD TO

NAME A. Phillips Hardware Inc.

ADDRESS 292 Central Ave.

Albany NY 12206

STOCK NO. 2908

MEMOS:

7

COST OF VEHICLE

| ACC. & OPT. EQUIP. | COST | | ACC. & OPT. EQUIP. | COST | | VEHICLE ONLY | | |
|---|---|---|---|---|---|---|---|---|
| A39 | 169 | 15 | C60 | 590 | 75 | | | |
| AU3 | 136 | 15 | D64 | 40 | 80 | TOTAL FACT. INSTALLED ACC. & OPT. EQUIP. | | |
| A01 | 89 | 25 | D68 | 23 | 10 | TOTAL DLR. INSTALLED ACC. & OPT. EQUIP. | | |
| A31 | 205 | 70 | D84 | 119 | 85 | | | |
| BC5 | 109 | 65 | F40 | 22 | 10 | | | |
| B10 | 41 | 65 | K35 | 136 | 00 | | | |
| B32 | 13 | 60 | N18 | 39 | 15 | | | |
| B33 | 9 | 35 | N33 | 84 | 15 | | | |
| B84 | 45 | 05 | N95 | 130 | 05 | DLR. DEL. & HAND. | | |
| B93 | 21 | 25 | P42 | 111 | 42 | GAS | | |
| CD4 | 41 | 65 | QLZ | 60 | 35 | | | |
| C49 | 112 | 20 | TR9 | 35 | 70 | TOTAL | | |

TOTAL COLUMN

FINANCING

| | |
|---|---|
| FIN. CO. | |
| AMT. $ | 11,629.47 |
| NOTE No | 389.44 |
| DATE DUE | 60.00 |
| DATE PAID | 11,240.03 |
| 5% | 648.40 |

GROSS PROFIT WASHOUT

| | |
|---|---|
| TOTAL NEW VEH. SALES PRICE | 11976.00 |
| TOTAL NEW VEH. COST | 10591.63 |
| TOTAL NEW VEH. GROSS PROFIT | 1384.37 |
| LESS: DISCOUNT/ OVERALLOWANCE | |
| GROSS PROFIT LESS DISC/OA | 1384.37 |

**USED**

ESTIMATED RECONDITIONING: 1ST TRADE | 2ND TRADE | 3RD TRADE

STOCK No. 2056 MAKE Chev. 19 81 APP. VALUE 5450.00

BODY Wagon V.I.N. 2G1AL35J5B1101367

LIC. No. TITLE No. D'Antonio DATE IN 11/2/82

SOLD TO R. J. Marshall Sr. DATE 4/1/83

ADDRESS 385 Morris St. Albany NY 12208

INV. No. 25337 SALESMAN Rouse COMM 192.30

STOCK No. MAKE 19 APP. VALUE

| RECONDITIONING DATE | R.O. No. | AMOUNT | APPRAISED VALUE PLUS RECONDIT'G A | INV'T'Y ADJUST-MENTS B | ADJUSTED INVENTORY VALUE C | NET SALE ※ D | GROSS PROFITS PER USED VEH. (ADD CUMULATIVE) |
|---|---|---|---|---|---|---|---|
| 11/3 | 25848 | 333.14 | | | 5783.14 | | |
| 7/4 | 26305 | 48.55 | | | 5781.69 | | |
| 3/10 | 26455 | 180.27 | | | 3961.96 | | |

USE COLUMNS "A" AND "D" TO DETERMINE THE GROSS PROFIT ON EACH USED UNIT

GROSS PROFIT 6711.00 ✓ 749.04

CUMULATIVE

GROSS PROFIT

CUMULATIVE

GROSS PROFIT

| | | |
|---|---|---|
| STOCK NO. 2908 | ORDER NO. 685728 | DATE 8/6/82 |
| MODEL 1BN35 Wagon | SER. 2G1AN35H2C1 269088 | MTR. V8 |
| BODY COLOR JADE | BODY STYLE 82-1BN35 | TRIM 47D |
| KEY 48E7 59H5 | BODY 451185 | PAINT 49 |

OPTIONS

INV. No. SALESMAN COMM.

※ NET SALE Is Sale Price Less Excess Allowance on Trade In, If Any. F-FACT. INSTALLED D-DEALER INSTALLED

TOTAL RETAINED GROSS PROFIT 2133.41

# NEW & USED CAR RECORD

FORM SA-294-6 (4-71)
RING BINDER 8R9-710
DELUXE BINDER 8PO-710
STANDARD BINDER 8PO-710
THE REYNOLDS & REYNOLDS CO.
COLUMBUS, O., DALLAS, LOS ANGELES
LITHO IN U.S.A.

## NEW CAR

### PURCHASE DATA

| DATE | MAKE | MODEL | SERIES | V.I. OR SERIAL NO. | COLOR | KEY NO. |
|---|---|---|---|---|---|---|
| | | | | Lawrence 2/82 | | |

PURCHASED FROM 1001156613 6/27 2.2

INT. NO.

| SOLD BY | COMM | DATE SOLD | INT. NO. |
|---|---|---|---|
| LoUri | 187.00 | 4/5/83 | 23289 |

### SOLD TO

NAME Lawrence Clark
ADDRESS 31 Marcon Ave.
Albany NY 12203

STOCK No. 2732
MEMOS:
C

### COST OF CAR

| ACC. & OPT. EQUIP. | COST | | ACC. & OPT. EQUIP. | COST | |
|---|---|---|---|---|---|
| A01 | 89 | 80 | QZJ | 208 | 68 |
| B32 | 13 | 60 | TTS | 8 | 50 |
| B33 | 9 | 35 | UA1 | 21 | 25 |
| B93 | 21 | 25 | UF7 | 54 | 40 |
| C49 | 112 | 20 | UN3 | 235 | 45 |
| C60 | 590 | 75 | V30 | 47 | 60 |
| D35 | 48 | 45 | 26C | 152 | 15 |
| D84 | 125 | 80 | | | |
| E41 | 28 | 05 | | | |
| N18 | 33 | 15 | | | |
| N33 | 84 | 15 | | | |
| N95 | 130 | 05 | | | |

| CAR ONLY | TOTAL COLUMN |
|---|---|
| TOTAL FACT. INSTALLED ACC. & OPT. EQUIP. | |
| TOTAL DLR. INSTALLED ACC. & OPT. EQUIP. | |
| DLR. DEL. & HAND. | |
| GAS | |
| TOTAL | |

### FINANCING

| | |
|---|---|
| FIN. CO. | |
| AMT. $ | 9782.07 |
| NOTE NO. | 324.48 |
| DATE DUE | 60.00 |
| DATE PAID | 9462.59 |
| 5% | 540.80 |

### GROSS PROFIT WASHOUT

| | |
|---|---|
| TOTAL NEW CAR SALES PRICE | 9966.00 |
| TOTAL NEW CAR COST | 8861.79 |
| TOTAL NEW CAR GROSS PROFIT | 1104.21 |
| LESS: DISCOUNT/OVERALLOWANCE | |
| GROSS PROFIT LESS DISC/OA | 1104.21 |

## USED CARS

### ESTIMATED RECONDITIONING

| 1ST TRADE | 2ND TRADE | 3RD TRADE |
|---|---|---|
| | | |

STOCK No. 2379 MAKE Chev 19 80 APP. VALUE 2550.00
BODY Caprice 4dr HT V.I. OR SER. NO. 1N69AY293512
LIC. No. TITLE No. Lawrence DATE IN 4/5/83
SOLD TO Pamela Bissey DATE 4/13/83
ADDRESS 17 Murray Ave Waterford NY
INV. No. 25416 SALESMAN Martinez COMM NA
STOCK No. MAKE 19 APP. VALUE
BODY V.I. OR SER. NO.

| RECONDITIONING DATE | R.O. No. | AMOUNT | APPRAISED VALUE PLUS RECONDIT'G A | INV'T'Y ADJUST-MENTS B | ADJUSTED INVENTORY VALUE C | NET SALE * D | GROSS PROFITS FOR USED CAR (ADD CUMULATIVE) |
|---|---|---|---|---|---|---|---|
| 4/12 | 20496 | 240.44 | | | 2790.44 | | |
| | | | | | | 3266.00 | GROSS PROFIT 475.56 |
| | | | | | | | CUMULATIVE |
| | | | | | | | GROSS PROFIT |
| | | | | | | | CUMULATIVE |
| | | | | | | | GROSS PROFIT |

USE COLUMNS "A" AND "D" TO DETERMINE THE GROSS PROFIT ON EACH USED UNIT

| STOCK NO. | | ORDER NO. | DATE |
|---|---|---|---|
| 2732 | | 6YQ647 | 7/1/82 |
| MODEL 1AW19 | | SER. 1G1AW19R4OG 134976 | MDL. L4 |
| BODY COLOR GRAY | | BODY STYLE 82-1AW19 | TRIM FDD1 |
| KEY 46E1 | 6200 | BODY 082524 | PAINT 80 |

OPTIONS

* NET SALE Is Sale Price Less Excess Allowance on Trade In, If Any.
F-FACT. INSTALLED
D-DEALER INSTALLED

TOTAL RETAINED GROSS PROFIT 1579.77

# NEW & USED VEHICLE RECORD

FORM SA-284-6 (11-80)
RING BINDER SRB-710
DELUXE BINDER SPD-710
STANDARD BINDER SPB-710

**NEW**

PURCHASE DATA M C Hallman 10/82

| DATE | MAKE | MODEL | SERIES | V.I.N. | KEY NOS. |
|---|---|---|---|---|---|
| | | | | | |

| PURCHASED FROM | | | INV. NO. | COLOR |
|---|---|---|---|---|
| 10000377789 | 9/2 | 3.3 | | |

| SOLD BY | COMM | DATE SOLD | INV. No |
|---|---|---|---|
| Boocock | 144.11 | 5/9/83 | 20083 |

SOLD TO
NAME Darril L. Wilson
ADDRESS 1014, Iris Ct.
Schenectady NY 12307

STOCK No. 22
MEMOS:
Fd

COST OF VEHICLE

| ACC. & OPT. EQUIP. | COST | | ACC. & OPT. EQUIP. | COST | |
|---|---|---|---|---|---|
| AG9 | 178 | 50 | C60 | 616 | 25 |
| AU3 | 144 | 50 | D64 | 40 | 80 |
| A01 | 89 | 25 | D68 | 75 | 65 |
| A31 | 216 | 25 | F40 | 22 | 10 |
| BC5 | 109 | 65 | K35 | 144 | 50 |
| BX5 | 260 | 95 | N18 | 33 | 15 |
| B1Q | 41 | 65 | N33 | 39 | 25 |
| B32 | 14 | 45 | N95 | 130 | 05 |
| B33 | 10 | 20 | QLZ | 60 | 35 |
| B84 | 46 | 25 | TR9 | 27 | 20 |
| CD4 | 41 | 65 | TT5 | 8 | 50 |
| C49 | 114 | 25 | T87 | 46 | 75 |

| TOTAL COLUMN | |
|---|---|
| VEHICLE ONLY | |
| TOTAL FACT. INSTALLED ACC. & OPT. EQUIP. | |
| TOTAL DLR. INSTALLED ACC. & OPT. EQUIP. | |
| DLR. DEL. & HAND. | |
| GAS | |
| over TOTAL | |

FINANCING

| | |
|---|---|
| FIN. CO. | |
| AMT. $ | 11,959.57 |
| NOTE No | 398.40 |
| DATE DUE | 60.00 |
| DATE PAID | 11,501.17 |

GROSS PROFIT WASHOUT

| | |
|---|---|
| TOTAL NEW VEH. SALES PRICE | 12673.00 |
| TOTAL NEW VEH. COST | 11617.87 |
| TOTAL NEW VEH. GROSS PROFIT | 1055.13 |
| LESS: DISCOUNT/OVERALLOWANCE | |
| GROSS PROFIT LESS DISC/OA | 1055.13 |

**USED**

ESTIMATED RECONDITIONING

| 1st TRADE | 2nd TRADE | 3rd TRADE |
|---|---|---|
| | | |

STOCK No. 2471 MAKE Chev 19 80 APP. VALUE 5500.–
BODY Caprice Wagon V.I.N. 1N35HAJ87823
LIC. No. TITLE No Lawrence DATE IN 5/4/83
SOLD TO Walter A Woodley DATE 6/15/83
ADDRESS 115 N. Greenbush Rd, Troy NY
INV. No. 26842 SALESMAN Boocock COMM. 77.00

STOCK No. MAKE 19 APP. VALUE
BODY V.I.N.

| RECONDITIONING DATE | R.O. No. | AMOUNT | | APPRAISED VALUE PLUS RECONDIT'G A | INV'T ADJUST-MENTS B | ADJUSTED INVENTORY VALUE C | | NET SALE * D | GROSS PROFITS PER USED VEH. (AND CUMULATIVE) |
|---|---|---|---|---|---|---|---|---|---|
| 6/27/83 | 26590 | 477 | 40 | | | 5977 | 40 | | |
| 6/27/83 | 26795 | 34 | 15 | | | 6011 | 55 | | |
| 6/27 | 26806 | 8 | 10 | | | 6019 | 65 | | |

USE COLUMNS "A" AND "D" TO DETERMINE THE GROSS PROFIT ON EACH USED UNIT

| NET SALE * D | GROSS PROFIT |
|---|---|
| 6816.00 | 796.35 |
| | CUMULATIVE |
| | GROSS PROFIT |
| | CUMULATIVE |
| | GROSS PROFIT |

Not Trade

| STOCK NO. | ORDER NO | DATE |
|---|---|---|
| XX 22 | 6V2891 | 9/10/82 |

| MODEL | SER. | MTR. |
|---|---|---|
| Cap 1BN35 Wgn | 2G1AN35H6D1 109748 | V8 |

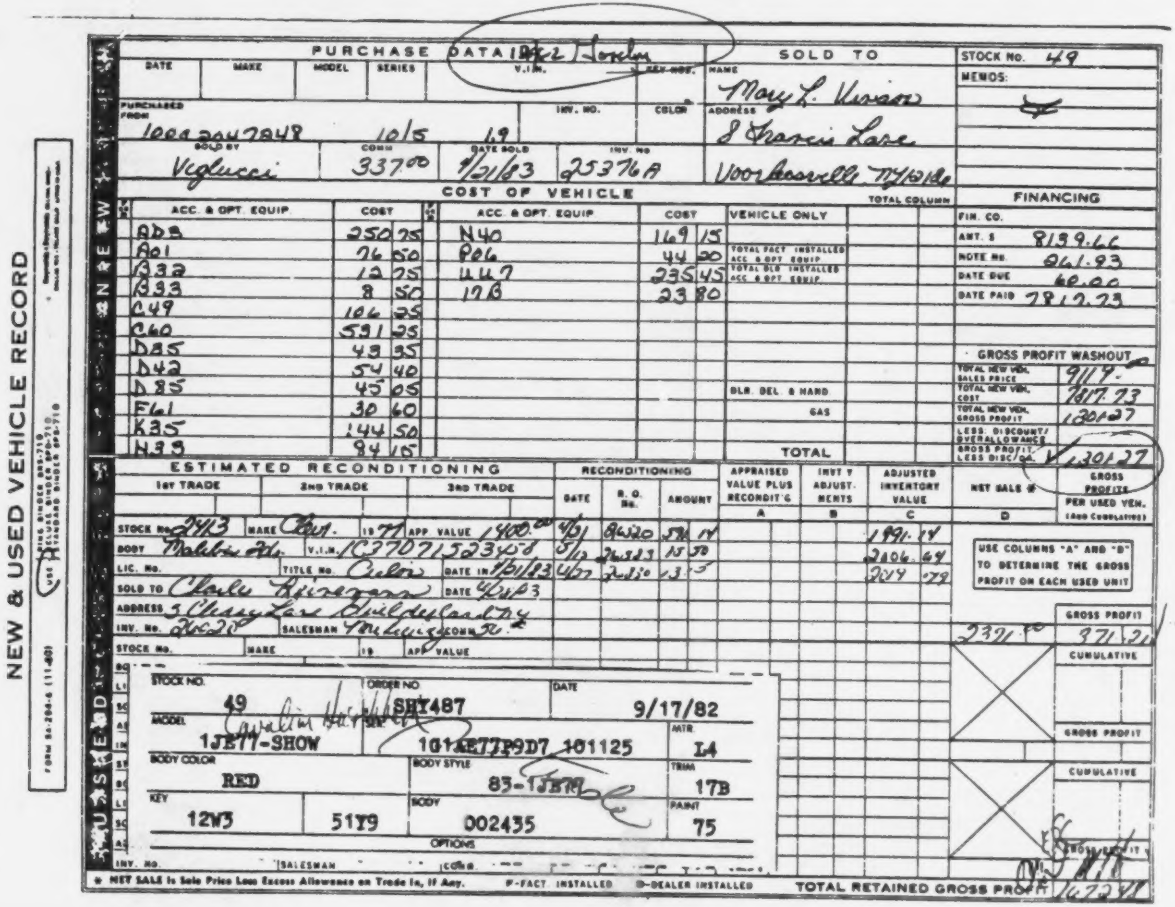
| BODY COLOR | BODY STYLE | TRIM |
|---|---|---|
| WHITE | 83-1BN35 | 77I |

| KEY | | BODY | PAINT |
|---|---|---|---|
| 21E9 | 94Y6 | 433619 | 11 |

OPTIONS

* NET SALE is Sale Price Less Excess Allowance on Trade In, If Any. F-FACT. INSTALLED D-DEALER INSTALLED

TOTAL RETAINED GROSS PROFIT 1851.48



## NEW & USED VEHICLE RECORD

FORM 54-204-6 (11-80)

**PURCHASE DATA** 1982 Joselyn

| DATE | MAKE | MODEL | SERIES | V.I.N. | KEY NOS. |
|---|---|---|---|---|---|
| | | | | | |

PURCHASED FROM 1002 2047848 10/5 49

INV. NO.

COLOR

| SOLD BY | COMM | DATE SOLD | INV. NO |
|---|---|---|---|
| Viglucci | 337.00 | 4/21/83 | 25376A |

**SOLD TO**

NAME Mary L. Vivian

ADDRESS 8 Francis Lane

Voorheesville NY 12186

STOCK No. 49

MEMOS:

**COST OF VEHICLE**

| ACC. & OPT. EQUIP | COST | | ACC. & OPT. EQUIP | COST | | VEHICLE ONLY | TOTAL COLUMN | |
|---|---|---|---|---|---|---|---|---|
| AD3 | 250 | 75 | N40 | 169 | 15 | | | |
| A01 | 76 | 50 | P06 | 44 | 20 | TOTAL FACT INSTALLED ACC. & OPT. EQUIP | | |
| B32 | 12 | 75 | U47 | 235 | 45 | TOTAL DLR INSTALLED ACC. & OPT. EQUIP | | |
| B33 | 8 | 50 | 17B | 23 | 80 | | | |
| C49 | 106 | 25 | | | | | | |
| C60 | 591 | 25 | | | | | | |
| D35 | 43 | 35 | | | | | | |
| D42 | 54 | 40 | | | | | | |
| D85 | 45 | 05 | | | | DLR. DEL. & HAND | | |
| F61 | 30 | 60 | | | | GAS | | |
| K35 | 144 | 50 | | | | | | |
| N33 | 84 | 15 | | | | TOTAL | | |

**FINANCING**

| | |
|---|---|
| FIN. CO. | |
| AMT. $ | 8139.66 |
| NOTE No. | 961.93 |
| DATE DUE | 60.00 |
| DATE PAID | 7812.73 |

**GROSS PROFIT WASHOUT**

| | |
|---|---|
| TOTAL NEW VEH. SALES PRICE | 9119.00 |
| TOTAL NEW VEH. COST | 7817.73 |
| TOTAL NEW VEH. GROSS PROFIT | 1301.27 |
| LESS: DISCOUNT/ OVERALLOWANCE | |
| GROSS PROFIT LESS DISC/OA. | ✓ 1301.27 |

**ESTIMATED RECONDITIONING**

| 1st TRADE | 2nd TRADE | 3rd TRADE |
|---|---|---|
| | | |

STOCK No. 2413 MAKE Chev. 1977 APP. VALUE 1400.00

BODY Malibu 2dr. V.I.N. 1C37U71523458

LIC. No. TITLE No. Color DATE IN 4/21/83

SOLD TO Charles Heinemann DATE 4/29/83

ADDRESS 5 Cherry Lane Guilderland NY

INV. No. 26628 SALESMAN McGuinness COMM 50.00

STOCK No. MAKE 19 APP. VALUE

| RECONDITIONING DATE | R.O. No. | AMOUNT | | APPRAISED VALUE PLUS RECONDIT'G A | INV'T Y ADJUST-MENTS B | ADJUSTED INVENTORY VALUE C | | NET SALE ★ D | GROSS PROFITS PER USED VEH. (And Cumulative) |
|---|---|---|---|---|---|---|---|---|---|
| 4/21 | 26320 | 591 | 14 | | | 1991. | 14 | | |
| 5/12 | 26383 | 15 | 50 | | | 2006. | 64 | | |
| 4/27 | 26310 | 13 | 15 | | | 2019 | 79 | | |

USE COLUMNS "A" AND "B" TO DETERMINE THE GROSS PROFIT ON EACH USED UNIT

| | GROSS PROFIT |
|---|---|
| 2391.00 | 371.21 |
| | CUMULATIVE |
| | GROSS PROFIT |
| | CUMULATIVE |
| | GROSS PROFIT |

| STOCK NO. | ORDER NO | DATE |
|---|---|---|
| 49 | SHY487 | 9/17/82 |

Cavalier Hatchback

| MODEL | SER. | MTR. |
|---|---|---|
| 1JE77-SHOW | 1G1AE77P9D7 101125 | L4 |

| BODY COLOR | BODY STYLE | TRIM |
|---|---|---|
| RED | 83-1JE77 | 17B |

| KEY | | BODY | PAINT |
|---|---|---|---|
| 12W3 | 51Y9 | 002435 | 75 |

OPTIONS

INV. NO. SALESMAN COMM.

★ NET SALE Is Sale Price Less Excess Allowance on Trade In, If Any. F-FACT. INSTALLED D-DEALER INSTALLED

TOTAL RETAINED GROSS PROFIT 1672.48

**ERB & COMPANY**
*Accountants • Auditors*
250 WEST 57th STREET
NEW YORK, N.Y.10107
TELEPHONE: 212-247-5225

March 3, 1983

The Honorable Daniel Rostenkowski
House of Representatives
Washington, D.C. 20515

Re: Proposed Income Tax Regulations
on Fringe Benefits

Dear Sir:

Enclosed is a copy of a letter dated 1/15/81 from former Treasury Secretary G. William Miller to you regarding taxation of fringe benefits. Included with the letter was a copy of proposed regulations for Code Section 61 dealing with fringe benefits. We do not find that these regulations have ever been finalized.

We represent a large number of automobile dealers and we are concerned with the taxability (or non-taxability) of vehicles assigned to dealership employees. Prior to 1975, these vehicles were treated under the provisions of the old fringe benefits regulations, i.e. essentially the cars were furnished to the employees as a working condition and it was recognized that there was some personal use such as commuting back and forth to work. However, under the provisions of Section 61, as long as the personal use represented only a small amount of total usage and use of the vehicle resulted in little or no cost to the employer, this personal use was not taxable to the employee.

Like Mr. Miller, we are looking for coherent and equitable guidelines. We propose that a log book be maintained in every demonstrator or other vehicle assigned to dealership personnel and that exact records of usage (in terms of miles) be maintained in this log book. At such time as the vehicle is turned back to the dealership for sale, if the total personal miles were less than one-third of total use, then use of that vehicle would be non-taxable. If personal usage exceeded one-third of total usage, then the individual would be taxed at an agreed rate per mile for all personal usage. We believe that such a regulation would be equitable to all parties and it would provide a tax on all those vehicles that were used mostly for personal business.

If we can be of any help in furnishing information or any other services in connection with this regulation, please let us know.

Very truly yours,

George L. Erb

GLE:d

Copy to: Senator Patrick Moynihan

WOLF AND COMPANY
CERTIFIED PUBLIC ACCOUNTANTS
ONE PENN PLAZA
NEW YORK, NY 10001

OFFICES IN
PRINCIPAL CITIES

212 · 594-8100

November 12, 1975

TO: All Automotive Clients

SUBJECT: Demonstrators

Attached to this memorandum is a copy of a letter we have sent to the U.S. Treasury Department and to Internal Revenue Service regarding the use of demonstrator cars by dealership personnel.

The new regulations as proposed, would impose a tax on every dealership employee for the use of a demonstrator. This tax would be measured by the fair rental value of the vehicle used. The regulation is predicated on the government's assumption that the use of the cars is primarily personal and that the dealership incurs a loss because of use of these cars by the employees.

The problem is that the government makes no provision for an examination of the facts in each individual case. Instead, the examining agent is virtually given a mandate to impose personal income tax on all usage of a demonstrator. Because Internal Revenue Service must enforce all regulations literally, there could be no relief from the imposition of this tax through the normal IRS appeal channels. The only recourse left to the taxpayer would be injunctive action through the courts to have the law set aside. For this reason, we recommend that every dealer write to the Treasury Department (same address as in the heading of our letter attached) calling attention to our letter and asking that full consideration be given to the facts stated therein.

Even a change in the regulation permitting incidental personal usage, however, will require each dealer to carefully consider his practices regarding assignment of demonstrators. If we prevail in the current controversy, it would seem likely that each salesman would be permitted the use of one demonstrator. Additionally, certain of the management personnel could use demonstrators without incurring tax liability. In all cases it would be necessary to be prepared to show the business use of the car if requested by an examining agent and to prove that personal use is incidental to business use. We would also presume that you would be able to prove that no economic loss was incurred by the dealership as a result of demonstrator usage.

Our position is that the demonstrator is not a family car. Assignment of more than one car to an employee (or officer), however, refutes this position and certainly any employee would be taxed on the use of more than one car. High mileage, unlimited gasoline usage, absence of the car from the premises for prolonged periods, naming of minor children in the insurance policies and personal registration of the vehicle are all factors that would indicate more than "incidental" personal usage.

On the positive side, keep a log book in the car and record each business trip or demonstration. It may even encourage your salesmen to do more demonstrating. If any work is done to the car and a claim is filed with the factory or an insurance carrier, make sure the claim is referenced to the demonstrator involved.

If any employee does have a car for use by some other member of his family, this is income to the employee and a monthly rental charge should be put through the payroll journal and included in the employee's total income at year-end.

It has come to our attention that, even at this time, certain IRS Districts have instructed agents to charge all dealerships a penalty for failure to include personal use of an automobile on the W-2 forms at year-end and to impose additional tax to the dealerships based on the fair rental value. This action seems arbitrary and capricious and we do not believe that any dealer should agree to such an adjustment until he has at least reviewed all the facts with his tax counsel. After all, if there was no personal usage, then there is no requirement that the employer withhold any tax or report any income to I.R.S.

We believe that judicious use of demonstrators will not result in any additional tax to you or your employees. Careless use of demonstrators can prove expensive to you and to your employees.

George L. Erb
WOLF AND COMPANY

Encl.

WOLF AND COMPANY
CERTIFIED PUBLIC ACCOUNTANTS
ONE PENN PLAZA
NEW YORK, NY 10001

OFFICES IN
PRINCIPAL CITIES

212-594-8100

October 31, 1975

Office of the Assistant Secretary
of the Treasury for Tax Policy
Washington, D.C. 20220

Gentlemen:

This is in reference to the discussion draft of the proposed regulations section 1.61-16 and your invitation for comments on the same. Our specific comments are limited to Example (14). At issue in that example is whether employees of an automobile dealership have compensation resulting from use of a car furnished by the employer.

Our firm represents many hundreds of automobile dealerships throughout the United States. We are, therefore, intimately familiar with dealership accounting and systems and, in particular, with the matter of company car and/or demonstrator usage. Because of this knowledge, we question whether the factual assumptions and conclusions contained in Example (14) comport with the general custom and practice in the automotive industry. Specifically, we question (1) the unqualified statement that the employer receives a reduced price when the demonstrators are sold; (2) that the employer incurs substantial additional cost; and (3) the assumption that the cars are primarily for personal use.

The dealer rarely incurs any additional cost from business or personal use of demonstrators. It is the practice of most dealers to leave a demonstrator in service for no more than 5,000 miles at which point it is returned to new car inventory and sold at the same approximate profit as other new cars. As for the maintenance expense of these vehicles, it is generally handled as follows:

1. If the dealer has his own gas pump, the employee using the car is permitted to draw enough gasoline weekly to cover his estimated needs for business use. Any other gas must be purchased by the employee.

2. Any repairs required to be made are covered by factory warranty and therefore result in no expense to the dealer.

3. The cost of repairing any damage to the car is charged to the employee using the car unless such damage is reimbursed by insurance.

4. Because of the short period of usage of the vehicle, such things as tune-ups and lubrication are not required.

5. Insurance for these cars is provided under a blanket policy and the cost remains the same whether the car is used solely for business or for business and pleasure.

It is our position that if cost to the dealer is one of the principal criteria for determining whether the employee realizes income from the use of demonstrator cars, such a determination should be made on a case-by-case basis. Each dealership maintains records reflecting the exact amount of profit on the sale of any vehicle and the expenses attributable to that vehicle while in the dealer's possession. Our experience indicates that in the majority of cases involving demonstrators with under 5,000 miles, the dealer does not incur significant cost in furnishing demonstrators to employees.

Also relevant to the discussion is the statement contained in Example (14) that "the employees use the automobiles primarily for personal use." Once again, our experience does not support this factual assumption. The majority of demonstrators are assigned to members of the sales force for the very obvious reason that they are to be used to demonstrate to customers. To illustrate the point, we provide below a typical assignment of demonstrator cars in a dealership:

President
Secretary-Treasurer
General Manager
Sales Manager(s)
Salesmen
Service Manager
Parts Manager
Demonstrator Pool

It will be found on examination that each employee has a different model. Using a Chevrolet dealership as our example, the President might have a Caprice, the Secretary-Treasurer a

Chevelle model, the General Manager a Monte Carlo, the New Car Sales Manager a station wagon in the Impala line. The New Truck Manager may be assigned to a passenger car, but in many cases his vehicle will be an El Camino pickup truck. The general idea is to have one car of every model available for demonstration use. The cars are required ~~to~~ be on the dealership premises available for use and demonstration each business day. That an individual is assigned a car does not mean that he alone has use of that car. A mechanic may take the Truck Manager's car to pick up a needed part at another dealership. A salesman who drives a Nova may want to demonstrate a Monte Carlo so he may take the General Manager's car, unless the Finance Manager is using it to deliver some notes to the local G.M.A.C. office. The car that any employee is driving in the morning may be sold in the afternoon and that employee may end up driving a pool car that evening. It should be noted that these demonstrators are not "family cars." They are not made available during business hours for personal use by family members and therefore, most dealership employees own their own family car.

Although most dealership employees drive a company-owned car home at night and back to work in the morning, many salesmen use these cars in the evening to demonstrate to prospective buyers. Moreover, the Parts Manager may drop off the night deposit at the bank on his way home, the Service Manager may drop his car at a customer's house as a "loaner" and drive the customer's car home for delivery to the shop the following day for repairs, the General Manager may drive to a Rotary Club dinner with the car before going home, and the President may drive from home to the bank in the morning.

Although it is arguable that Example (14) only requires employees to have compensation income where it is established the cars are used primarily for personal purposes and the cost thereof to the employer is substantial, we are concerned that an examining agent will interpret Example (14) as a mandate to impose personal income tax on all usage of a demonstrator without examining the facts in each case. If such a position was taken, every employee using a dealership car must pay a tax equal to the fair rental value of that particular car. Thus, if a Cadillac dealer assigns an El Dorado to Salesman A and the fair rental value is $275 per month, the Salesman must pay a tax on $3,300 of income each year for the privilege of working at the dealership. If he sold Chevrolets, it might only cost him the tax on $135 per month to hold his job. Obviously, the Cadillac dealer may have difficulty employing salesmen or his salesmen may drive Ford Pintos or Plymouth Dusters rather than a Cadillac to work and to see potential customers. Should his salesmen drive competitor's cars, the dealer would lose the benefit of free advertising through the use of demonstrators.

In conclusion, we believe that Example (14) should be rewritten so that the determination of whether employees have compensation from the use of demonstrators will be based on the facts and circumstances of each particular case. The demonstrator is one of the principal selling tools of the automobile salesman as well as a form of institutional advertising by the dealer. In the majority of cases, the use of demonstrators by employees does not result in substantial additional costs to the dealer. Indeed, any personal benefit to the employee is incidental to the business use of the car. Moreover, in our judgment, any personal benefit from "demo" use is analogous to department store discounts, free transportation for air, rail, and bus company employees and the like, all of which are non-taxable fringe benefits under the proposed regulation. We see no legal justification for treating "demo" use differently.

If additional data or information is needed, we will be pleased to furnish it.

Very truly yours,

George L.

cc: Commissioner of Internal Revenue
Attention: CC:LR:T
Washington, D. C. 20224
(4)

**Mr. Jenkins.** Mr. Turnbull, you are basically in agreement with the provisions that are in the bill?

**Mr. Turnbull.** Yes.

**Mr. Jenkins.** As is Mr. Erb, but with a few revisions.

**Mr. Erb.** The revisions that I spoke of, yes.

**Mr. Turnbull.** We are in agreement with the basic concepts of the bill, not only as applies to demonstrators but to the qualified discount.

**Mr. Jenkins.** Mr. Duncan.

**Mr. Duncan.** Thank you, Mr. Chairman. I want to thank both members of the panel.

Mr. Turnbull, an automobile salesman's sales ground just isn't on the lot or in the showroom, is it?

**Mr. Turnbull.** No, we actually had some different, you might say, conversation we wanted to give to the group as far as the testimony is concerned. In our text on page 5, we refer to the term "sales area" as used, you might say, in the so-called provision is not a defined term.

We think it is proper, since the sales area may vary depending on the location of the dealership, therefore, we think that to avoid confusion as far as the committee report, to make it clear that the term "sales area" relates to the geographical area that the dealership operates in and not just the dealership premise.

**Mr. Duncan.** All right. I have observed that some dealers have salesmen living in distant counties who represent them in those counties.

**Mr. Turnbull.** That is correct.

**Mr. Duncan.** And that is their sales area.

**Mr. Turnbull.** That is correct. To get back to the permanent use of the vehicle or so-called restrictions as to permanent use, we think in this instance that it is more, you might say, proper to allow the dealer to operate in a geographical area and since he cannot be confined to a particular area, a rural dealer is one that may have several counties under his so-called jurisdiction and that allows him to have the flexibility, if you will, to do that.

**Mr. McCarthy.** Mr. Duncan, along the line with what Mr. Turnbull said, we think it ought to be the general marketing area and that is specific enough because you can see where the dealer's sales registrations took place. In some cases, rural areas would have broad areas and there are other areas that would not be as broad with the other limitation on permanent use.

**Mr. Duncan.** I would hope we can define the general market area, yes.

Do you have a comment, Mr. Erb?

**Mr. Erb.** The sales agreement that the dealer has with the factory specifies a market area in which the dealer is the authorized franchised dealer for that brand of car.

There are specific points where the dealer may sell. This does not necessarily restrict a dealer's sales area, however. I think of a Chevrolet dealership located in Georgia in one particular county, for example, but he sells cars and trucks in two other counties besides that county in which he is located. Although his sales agreement only covers one county where the dealership is located, he does business in three counties.

Mr. DUNCAN. Thank you very much, Mr. Erb, Mr. Turnbull, and Mr. McCarthy.

Mr. TURNBULL. We thank you, gentlemen.

Mr. JENKINS. Our next panel includes, from the Airport Transportation Association, Norman Philion and William Hawkins; the Association of Flight Attendants, Linda A. Puchala; Independent Federation of Flight Attendants, Monica Kaufmann; and the National Business Aircraft Association, John Winant.

If that panel would come forward.

Your entire written statements will be made a part of the record and if you would, please summarize your statements.

Mr. Philion.

## STATEMENT OF NORMAN J. PHILION, EXECUTIVE VICE PRESIDENT, AIR TRANSPORT ASSOCIATION OF AMERICA; ACCOMPANIED BY WILLIAM M. HAWKINS, VICE PRESIDENT FOR FINANCE AND TAXATION

Mr. PHILION. Thank you, Mr. Chairman. As indicated, I am accompanied by William Hawkins, the association's vice president for finance and taxation. We are appearing on behalf of most of the major airlines of the United States.

The airline industry deeply appreciates the interest and initiative of the subcommittee chairman and Mr. Conable, and the staff, in developing H.R. 3525 and in calling this hearing.

Our interest in this matter arises because the personal travel privileges of airline employees, although not a form of compensation, have been drawn into the complex fringe benefit issue and the question of related tax policy. We have urged, therefore, that Congress resolve this issue by establishing practical and reasonable guidelines for tax treatment of fringe benefits.

The purpose of H.R. 3525 is to establish such guidelines and we welcome its consideration. We believe, however, that certain changes to the bill are in order both to assure consistency with statutory provisions and court decisions of longstanding, and in the interest of simple equity in view of longstanding airline industry practices.

The airlines have provided travel privileges to their employees and have exchanged such privileges with other airlines as a matter of common industry courtesy from the very beginning of commercial air service. For some 45 years, the airlines have been authorized by provisions of the Federal Aviation Act and its predecessor, the Civil Aeronautics Act of 1938, to issue passes for free or reduced rate transportation to employees and their families, as well as to the employees and their families of other airlines.

These personal travel privileges are not a form of compensation and they never have been considered a form of compensation. As written, H.R. 3525 would no longer permit the exchange of nontaxable personal travel privileges between airlines or the provision of nontaxable personal travel privileges to the parents of airline employees.

The airline and their employees are deeply concerned about these two omissions. We strongly urge that H.R. 3525 be amended to provide for interchange of travel privileges and a suggested amendment is attached to our prepared statement.

We also strongly urge inclusion of parents in the definition contained of 321(f)(1) of the bill. The need for the changes underlying the bill was highlighted at recent Senate Finance Committee hearings when the Treasury Department testified that its 1921 determination that railroad passes were gifts and therefore not taxable had been erroneously applied to airline travel privileges. This statement was made notwithstanding the fact that the Internal Revenue Service issued technical advice to two airlines in 1972 affirming the gift status of employee travel privileges.

Moreover, the Federal courts have consistently upheld the gift status of airline employees' travel privileges. For example, the district court in the *Braughton* case explored this fully concluding, and I quote,

> Said privileges are not obtained by TWA employees pursuant to any collective bargaining agreement, or assured to such employees by any contract of employment. Said passes are not a part of the wages or consideration paid to TWA employees for their services. The wages and salaries of TWA employees are not affected in any way by the pass privileges.

Mr. Chairman, I will conclude by urging your consideration of the suggested changes we have made in the oral presentation, as well as the amendments we suggest in our statement. We would be glad to work with you and the committee staff in any way we can.

Thank you.

[The prepared statement follows:]

## STATEMENT OF NORMAN J. PHILION, EXECUTIVE VICE PRESIDENT, AIR TRANSPORT ASSOCIATION OF AMERICA

### SUMMARY

(1) Airline industry interest in H.R. 3525 arises because the personal travel privileges of airline employees, although not a form of compensation, have been drawn into the fringe benefit issue and the question of related tax policy.

(2) The airlines have urged Congress to resolve the issue by establishing practical and reasonable guidelines for the tax treatment of fringe benefits.

(3) H.R. 3525 is a step in the right direction but several changes are required to conform to long-standing federal laws, regulations, and court decisions to: Allow the exchange of non-taxable employee travel privileges between airlines, and include parents of employees among the group treated as employees.

### STATEMENT

My name is Norman J. Philion. I am Executive Vice President of the Air Transport Association of America, which represents the major segment of the U.S. airline industry. I am accompanied by William M. Hawkins, the Association's Vice President-Finance and Taxation. We appreciate the opportunity to present the views of our member airlines on H.R. 3525, the Permanent Tax Treatment of Fringe Benefits Act of 1983.

Our interest in this legislative matter arises in connection with the use of personal travel privileges by airline employees. Although these privileges are not, and never have been considered, a form of compensation, they have become a part of the broad, complex fringe benefit issue and the question of related tax policy. We have urged, accordingly, that Congress resolve the issue by establishing practical and reasonable guidelines for the tax treatment of fringe benefits. While we believe several changes to H.R. 3525 are required, we also believe this proposal represents a major step in the consideration necessary for the establishment of such guidelines.

We therefore welcome these hearings and commend you, Mr. Chairman, and Mr. Conable, as well as the staff for your initiative on this matter and the introduction of H.R. 3525.

As we have testified on previous occasions, the airlines believe that an employer should be allowed to provide its employees and their families with facilities, goods or services that exist incidental to the trade or business of the employer without their use being considered additional taxable income to the employee. H.R. 3525 excludes from consideration as taxable income only those goods and services provided to customers in the normal course of the trade or business. While this bill is somewhat more restrictive than we believe appropriate, it would allow airline employees and their immediate families to use the travel privileges extended by their employers without incurring any personal tax liability. However, several changes in this bill are essential to assure consistency with long-standing, soundly-based federal laws, regulations and court decisions.

The airlines have provided travel privileges to their employees and have exchanged such privileges with other airlines from the very beginning of commercial air service. For some 45 years the airlines have been authorized by provisions of the Federal Aviation Act and its predecessor, the Civil Aeronautics Act of 1938, to issue passes for free or reduced-rate transportation to employees and their families, as well as to the employees and their families of other airlines. The pertinent language of Section 403 of the Federal Aviation Act specifically authorized the issuance and interchange between airlines of: ". . . tickets or passes for free or reduced rate transportation to their directors, officers, and employees (including retired directors, officers, and employees who are receiving retirement benefits from any air carrier), the parents and immediate families of such officers and employees, and the immediate families of such directors . . ."

H.R. 3525 would no longer permit the long-standing airline practice, sanctioned by law, of exchanging non-taxable personal travel privileges between airlines. The airlines and their employees are deeply concerned about this aspect of the bill.

The interchange of transportation passes has been traditional in the transportation industry since its beginning. In fact, the issuance of passes by a railroad company to employees of other railroads was provided for in the Hepburn Act of 1906 and is currently authorized in the Interstate Commerce Act (49 USC Section 10722(d)(2)). Moreover, federal courts relying on these laws have consistently held that both online and interchange passes are gifts and not compensation. For example, the Committee's attention is invited to the decisions of two United States district courts in *Braughton* v. *United Air Lines, Inc.*, 189 F.Supp. 137 (1960); and *Sims* v. *Northwest Airlines, Inc.* 269 F.Supp. 272 (1967)—cases involving on-line and interchange airline passes, respectively. Many similar decisions involving surface transportation have also been rendered by federal courts over the years. We strongly urge, therefore, that H.R. 3525 be amended to include these interchange travel privileges. Attached to this statement is suggested language for such an amendment.

Another area of great concern to the airlines and their employees is the failure to include parents of the employees among the group of "individuals treated as employees" in Section 132(f)(1) of H.R. 3525. As pointed our earlier in this statement, the Federal Aviation Act specifically authorized the issuance or interchange of travel privileges for "the parents" of airline employees. We see no justification for singling out "parents" for different treatment after all these years. The airlines and their employees strongly urge the inclusion of "parents" in the definition contained in Section 132(f)(1) of H.R. 3525.

Also of concern to the airlines, from a technical perspective, are the parenthetical references to "foregone revenue" and "determined without regard to any amount paid by the employee for such service" in Section 132(b)(2). The airlines believe that, as written, this section will be a source of constant discussions, arguments and conflict as to the meaning of these terms, between airlines and their employees on the one hand and IRS agents on the other. For example, the term "foregone revenue" is neither defined in the Code nor, in our judgment, is it definable. We believe the "no substantial additional cost" test in Section 132(b)(2) of H.R. 3525 is explicit and sufficiently clear for this purpose. We, therefore, recommend deletion of the two aforementioned parenthentical references.

The need for legislative guidelines most recently became evident at the June 22, 1983 Senate Finance Committee hearings when the Treasury Department testified that the Department's 1921 Office Decision determining that railroad passes were gifts and therefore not taxable had been erroneously applied to airline travel privileges. Nevertheless, the fact exists that the IRS had issued a "Technical Advice" to two airlines in 1972 affirming the gift status of employee travel privileges. Moreover, as previously stated, the federal courts have consistently upheld the gift status of airline employer travel privileges.

The District Court in the *Braughton* case had explored the nature of such gratuitous passes quite fully, concluding:

". . . Said privileges are not obtained by TWA employees pursuant to any collective bargaining agreement, or assured to such employees by any contract of employment. Said passes are not a part of the wages or consideration paid to TWA employees for their services. The wages and salaries of TWA employees are not affected in any way by the pass privileges." 189 F.Supp. 137, at 140.

The *Braughton* decision correctly applied to airline passes some landmark U.S. Supreme Court decisions regarding railroad passes dating back to the turn of the century. In those cases (*Northern Pacific R. Co.* v. *Adams,* 192 U.S. 441, 48 L.Ed. 513 (1904); and *Charleston & Western Carolina R. Co.* v. *Thompson,* 234 U.S. 576, 58 L.Ed. 1476 (1914), the Supreme Court upheld the assumption of the risks of carrier negligence by the employee in accepting the privilege of free transportation. In the *Charleston & Western Carolina* case, a Georgia state court had found that the pass was really not free, "but was issued upon consideration of the services of the employee." The Supreme Court reversed, in an opinion written by Justice Oliver Wendell Holmes, who provided the following analysis:

"The main question is whether, when the statute permits the issue of a free pass to its employees and their families, it means what it says. The railroad was under no obligation to issue the pass. . . . The antithesis in the statute is between the reasonable charges to be shown in its schedules and the free passes which it may issue only to those specified in the act. To most of those enumerated the free pass obviously would be gratuitous in the strictest sense, and when all that may receive them are grouped in a single exception, we think it plain that the statute contemplates the pass as gratuitous in the same sense to all. It follows . . . that even on the improbable speculation that the possibility of getting an occasional free pass entered into the motives of the employee in working for the road, *the law did not contemplate his work as a conventional inducement for the pass, but, on the contrary, contemplated the pass as being what it called itself, free.*" (emphasis added). Id. at 578, 58 L.Ed. at 1479.

These two Supreme Court decisions no doubt led directly to the terse language of O.D. 946, 4C.B. 110 (1921), in which the Internal Revenue Service determined that passes of this nature are not taxable. We can see no reason why the conclusion of some 62 years' standing is not valid today, and believe the Committee should affirm the non-taxable status—for on-line and interchange airline travel privileges.

H.R. 3525 also contains a provision regarding "on premises recreational facilities". Many companies, including airlines, that conduct extensive training programs for employees maintain facilities for housing trainees during the training period. The housing at many of these training locations includes recreational facilities similar to those found in hotels where trainees are housed in the absence of company-owned facilities. We believe there should be no difference in the tax treatment afforded on-premise housing which includes recreational facilities and comparable rental housing to accommodate employees on temporary assignment in the normal course of the employer's trade or business.

In conclusion, Mr. Chairman, the airline industry applauds the Subcommittee's efforts to clarify the tax status of non-statutory employee fringe benefits and we strongly urge that the suggestions we have made today be incorporated in the bill. The Association and its member carriers stand ready to work with you, the Committee, and the staff.

[Attachment]

### Proposed Amendment to H.R. 3525 To Provide for Interchange of Passes

Add to Special Rules in Subsection (g) of Section 132 as follows:

"Exclusions under subsection (a)(1) and (2) shall apply to such fringe benefits extended by employers to employees of other employers in the same trade or business where such interchange arrangements have been authorized by federal law or regulations issued thereunder, or by tradition and custom within the same trade or business."

Mr. **Jenkins**. Ms. Puchala.

## STATEMENT OF LINDA A. PUCHALA, PRESIDENT, ASSOCIATION OF FLIGHT ATTENDANTS, AFL-CIO

Ms. **Puchala**. I am Linda Puchala, president of the Association of Flight Attendants. We represent 21,000 flight attendants on 14 airlines. Since my written statement will be incorporated into the record, I will simply say that we reiterate Representative Glenn Anderson's testimony citing our opposition to taxation of fringe benefits for parents, also any taxing of interline passes, and placing any value on the passes for tax purposes.

Since airline deregulation, we have had many upheavals in the industry which have caused an increasing number of our members to consider commuting as an option for getting to work. We are concerned that a situation is developing here with this piece of legislation where our people cannot afford to move, yet they will be put in a position of not being able to commute either, which places them in a catch 22.

Our concern for the commuter has grown since some of our airlines have as many as 35 percent of our membership commuting. For instance, our members in Salt Lake City on Western; 80 percent of those members commute to work.

On the issue of the value of a pass—how does one determine the value of a pass granted only if space is available? How much is the flight worth when the airline employee may have to wait as long as 48 hours to get on an open flight? The employee may have to suffer substantial inconvenience in order to take advantage of this benefit. Because of the wide variation in company policies and utilization of pass benefits, the inequities of any program designed to tax the benefit would seem overwhelming. In addition, I would like to point out that any tax on the lowest fare between two points is not the answer, for these fares are for confirmed travel.

Although, if any of you have been bumped during your airline deregulation, I am sure you will dispute whether or not it is confirmed travel.

Those passengers traveling on space available who are bumped have to oftentimes incur hotel expenses and other transportation and food expenses while waiting for an available flight.

Those families that travel on space-available passes are known to carry their lunches with them.

Also, the idea that has been expressed here that food is automatically provided to space-available passengers is less than accurate, for flight attendants have been told to deny food to space-available passengers if there is not enough available for all those passengers on board the aircraft.

When you consider the increasing number of passengers flying on the discounted rate—approximately 80 percent of the paying passengers are flying at discounts in excess of 45 percent. When you consider the increasing number of passengers flying free under milage plus programs, it doesn't seem reasonable to start taxing space-available airline employee passes.

We stand ready to work with you and the committee staff and are anxious to answer any questions you may have regarding our testimony.

In addition, earlier today somebody mentioned the treatment of fringe benefits in Japan. We stand ready to use our connections within the AFL-CIO to provide that information to the subcommittee.

Thank you.

Mr. JENKINS. Thank you.

[The prepared statement follows:]

## STATEMENT OF LINDA A. PUCHALA, PRESIDENT, THE ASSOCIATION OF FLIGHT ATTENDANTS, AFL-CIO

Mr. Chairman and Members of the Subcommittee, I am Linda Puchala, President of the Association of Flight Attendants, AFL-CIO. On behalf of the 21,000 flight attendants AFA represents on 14 airlines, I would like to state our opposition to H.R. 3525, The Permanent Tax Treatment of Fringe Benefits Act of 1983.

AFA applauds the effort to provide a permanent rule for the tax treatment of fringe benefits. On several occasions since 1978 our membership has faced the uncertainty of Congressional action on the tax treatment of fringe benefits. On each occasion the moratoriums forbidding the taxation of fringe benefits were extended by Congress. It is time to put this issue at rest with a permanent moratorium following traditional practices. We find the Stark/Conable bill to be an unacceptable solution to the problem, however.

We oppose this bill for several reasons:

Taxing interline passes places a crushing burden on our commuter members who often must use these passes to get to and from their jobs.

Valuing the passes for tax purposes will be an administrative nightmare and cannot be done equitably.

Restricting the tax-free benefit to the employee, spouse and dependent children discriminates against the large number of flight attendants who are unmarried and/or childless.

First, the effect of such legislation would be devastating to our increasing number of commuters who must fly between their home cities and their flying jobs. Since airline deregulation, upheavals in the industry have forced over ten percent of our membership to be displaced as bases are closed and opened due to route restructuring. The city pairs served by those airlines which operated in 1978 have changed by approximately 50 percent or greater, according to Civil Aeronautics Board figures.

Because of the disruptions caused by deregulation, these people have been transferred to different bases as the airlines change route structures and close old bases. These employees may be transferred only temporarily, or they may be unable to relocate to the new base city. In these cases, interline passes enable them to "commute" by air to their jobs. Our more than 1,000 commuter members could not afford to pay for this transportation. Taxing this critical means of livelihood would be grossly unfair.

In 1978 we were told by Congress that there would be no harm caused to airline employees due to deregulation because we were to be protected by labor protective provisions. In 1983, we are still waiting to see this protection. Now, to add insult to injury, Congress is now telling us that we will be taxed for the privilege of holding on to our jobs, for the privilege of not joining millions of other Americans on the unemployment rolls.

Second, the hypothetical valuation and accounting for airline passes is a problem that even the most sophisticated computer could not overcome. Contrary to popular belief, the pass is not "free"; there is a cost incurred with all passes although it is at a substantial reduction from regular fares. This in itself presents an administrative problem for taxing passes.

How does one determine the value of a pass that is granted only if space is available? How much is a flight worth when the airline employee may have to wait as long as 48 hours to get an open flight? The employee may have to suffer substantial inconvenience in order to take advantage of this benefit, which may be restricted to specific times and geographical areas. Because of the wide variation in company policies and utilization of pass benefits, the inequities of any program designed to tax this benefit seem overwhelming.

Approximately 80 percent of revenue paying passengers are flying at an average discount of 45 percent. How does one assign a dollar value to a travel pass when revenue passengers on the same flight have paid a dozen different ticket prices depending on which discount or promotion was in effect at the time of their ticket purchases? Commuters on-call do not have the luxury of planning travel or meeting minimum stay requirements imposed for supersavers.

Therefore, it is obvious that it is difficult if not impossible to value these passes. In fact, the value is zero, according to economists. Airlines cannot store their product as manufacturers can, and wait for excess capacity to dry up. Since the marginal cost of selling an otherwise empty seat is close to zero, there is no floor to the discount a carrier can afford to offer if that discount will lure a paying passenger into an otherwise empty seat. If empty seats remain, there is no cost at all when an employee rides on a pass. An added injustice of this bill is its attempt to tax space-available employee passes while airlines "give away" tax-free reserved seats to passengers under "mileage plus" programs.

Finally, after nearly twenty years of intensive effort to eradicate all forms of discrimination, this legislation would codify a new form of discrimination against flight attendants who are unmarried or who have no dependent children. Since fifty percent of AFA flight attendants are unmarried and seventy-five percent have no dependent children, this legislation discriminates against the majority of flight attendants who lack the "appropriate" immediate family. Even parents and stepchildren who live in the flight attendant's household and are listed are dependents for income tax purposes would be taxed for airline passes under this legislation. We have recognized this form of discrimination and have made in-roads through our collective bargaining agreements to provide equitable pass benefits for all flight attendants. Needless to say, our efforts would be for naught should this bill be passed.

The majority of airline employees are flight attendants, mechanics, clerks, and fleet service workers. They are hard working middle-income career people, who already bear their full share of the nation's tax burden. Altering past practice in order to tax pass benefits is an ill-conceived notion which would be detrimental to our members' working lives. We urge your opposition to H.R. 3525.

Mr. JENKINS. Ms. Kaufmann.

## STATEMENT OF MONICA KAUFMANN, SECRETARY-TREASURER, INDEPENDENT FEDERATION OF FLIGHT ATTENDANTS

Ms. KAUFMANN. Mr. Chairman and members, thank you for inviting us.

I am Monica Kaufmann, secretary-treasurer of the Independent Federation of Flight Attendants. We represent 6,500 attendants on TWA property. Our members would be directly affected by any action that would result in the taxation of employee travel privileges. To the extent that the provisions of H.R. 3525 would prohibit such taxation, we strongly support it. However, to the extent H.R. 3525 would permit the taxation of so-called reciprocal travel made available by other air carriers, we vigorously oppose it. There is no valid reason and no practical distinction for treating the two types differently. Both should not be subject to taxation, as has been the case since the inception of air transportation.

The Internal Revenue Service's continued preoccupation with the matter of employee travel stems in large part from the widespread misunderstanding of the nature and extent of employee travel privileges in the air carrier industry. A good example of this misunderstanding is the notion that all the employee transportation is alike because it is standby travel. But there are many varieties of standby travel, different priorities, different classes of service, and similar factors.

These exist whether an employee is traveling on his employer's airline or that of another carrier. Yet, the Internal Revenue Service would value all standby travel the same as travel on a ticket offering a confirmed reservation. But the two are not at all comparable.

Standby travelers never know whether they will get a seat on the flight until the last few minutes. Some standbys may get a seat, while others are left behind, depending on the relative priority of their ticket, which in turn depends on their seniority, employee group or category, or whether they are employed by another airline. Airlines generally give their own employees priority.

Often, standbys will not get a seat on the flight of their choice, but will have to take a circuitous routing or rely on multiple connecting flights. They are frequently bumped along the way. They alone pay for any associated expenses such as hotels, et cetera, resulting from the bumping. Standbys often take flights at inconvenient times of the day or night just to be able to get a seat. Obviously, a passenger who travels standby does not get the same value as the person with a confirmed reservation. Yet, the Internal Revenue Service would value the standby travel as if the person received all the benefits of a confirmed passenger.

Even after the standby employee gets a seat, he or she does not get the same type of service. The seat itself is the leftover seat; the choice of a smoking or no smoking seat usually is not possible; you get what is left. Frequently, you do not get a meal or are served what is left.

I mention these factors, not to criticize or belittle the travel privileges that are offered, but to indicate that they are in no way comparable to those offered to the confirmed passenger. They should not be taxed as if they were comparable. The travel is truly provided at no additional cost to the airline and represents no foregoing of income, since the seat by definition cannot be sold.

Moreover, there is very little employee travel that is offered at no charge. An employee, depending on the type of standby travel being used, has to pay either a flat charge for each trip, or a charge based on 25 percent of the so-called basic fare in the market. In some cases, the percentage is 50 percent of the basic fare.

This raises an additional factor to consider that stems from airline deregulation. Since the CAB no longer regulates air fares, we have seen an explosion of discount and promotional fares that represent sharp discounts off the so-called basic fares. These fares generally offer the same amenities and a confirmed reservation as do the basic fares, but are subject to advanced purchase and minimum stay conditions.

In some cases, the difference between these deep discount fares that offer all the amenities of a confirmed reservation and the other features provided by a basic fare ticket and an employee standby ticket based on a percentage of the basic fare is minimal. The passenger flying on the deep discount fare is not taxed on the difference between what he pays and the full fare, yet the employee would be, and he or she is receiving less value.

Airline deregulation has created other problems that make it even more inequitable to tax employee travel. Because of the drastic restructuring of the airline industry under deregulation, there have been large-scale furloughs, employee bases have been closed, wholesale transfers required from one city to another and a variety of other events that directly impact on the life of the employee.

Due to economic and competitive conditions, TWA has both furloughed and displaced thousands of flight attendants since deregulation. Many flight attendants have families or homes in the community where they once worked and are forced to travel regularly from the city where they live to the city in which they are now required to originate their flight. Over half of the TWA flight attendants fly between their cities of residence and the cities where they are assigned to work. A large proportion of them are doing so because of involuntary transfers made after deregulation.

Flight attendants from California regularly fly many hours to get to St. Louis, New York, or other cities to which they have been assigned in order to perform their jobs. To tax their standby travel would be to force them to bear even more of the brunt of airline deregulation.

Again, because of deregulation, a transferred employee may find he or she can no longer travel on the employer's airline to get to the job site because, using the new ability to drop routes at will, the employer may decide to abandon the flights the employee relied upon to travel to the job. An employee is then required to purchase a standby ticket on another carrier under the reciprocal arrangements the carriers have developed. Under H.R. 3525, that employee's travel would then become subject to tax. Once again, the employee would be bearing the brunt of airline deregulation.

The difficulties in valuation I have mentioned make it clear that any attempt to fairly determine the dollar value of what has been received will result in arbitrary penalties to the employee. And why single out the employee? What about travel agents who regularly received free familiarization travel? What about the free travel, with confirmed space, that is offered to the public in the frequent flyers programs? And what about the free travel on a confirmed basis that is provided under the barter programs the CAB now permits?

Airlines give away tickets providing confirmed space in exchange for services supposedly provided by others, such as advertising agencies. Some of these represent barter in name only. And the person receiving these tickets is free to sell them to anyone at whatever price he wishes. Is the ultimate recipient taxed on the difference between what he pays and the price of the full fare ticket? Of course not. But the employee, who gets only a standby seat, is being asked to pay.

Employee standby travel, whether on the employee's own airline or on that of another, has been recognized from the beginning of the airline industry as not involving taxable income. It should remain that way.

Mr. JENKINS. Thank you.

Mr. Winant.

## STATEMENT OF JOHN H. WINANT, PRESIDENT, NATIONAL BUSINESS AIRCRAFT ASSOCIATION, INC.

Mr. WINANT. Good morning, sir. I am John Winant. I am here to speak for the interests of business aviation and specifically for the more than 2,500 companies which are members of NBAA, and which collectively operate more than 5,000 aircraft in the day-to-day conduct of their business. I am president of the National Business Aircraft Association.

I believe it is necessary for me to initially draw a line, one which does not involve the sharing of common interests with the other panel members, but which simply involves the nature of the kind of transportation which is supplied by the business aviation community as opposed to that supplied by the air carrier community.

Business aircraft consists of the transportation of persons on a not-for-hire basis. That is, not on a basis of selling tickets to the general public.

It involves use of aircraft for the transportation of company employees and guests in direct support of the company's principal purposes, yet, incidental to those purposes. Business aircraft are income generators to the owning companies in that they expedite and they maximize the flow of communication, transportation of personnel, and through those purposes maximize the use of time.

The technical explanation for H.R. 3525 proposes that allowing an employee of a firm to use for personal purposes an otherwise empty seat on a company aircraft which is on a business mission should be a taxable benefit to the employee.

We respectfully disagree with that proposal. We feel that empty seat transportation of employees on company aircraft does indeed comply fully with the spirit and we believe with the letter of three of the exemptions from taxation ennunciated in section 2 of the bill.

First, the no additional cost service principle. The added cost of using an otherwise empty seat on a company aircraft to us is nonexistent. It meets the same terms and conditions by which the use of an otherwide empty seat on an airliner by an airline employee would be at no substantial additional cost, according to the technical explanation, and therefore would be not taxable.

We further note that this practice is addressed in the technical explanation in terms of carriage of spouse and children, also, of the employee and we would point out that we agree that the same kind of principle should apply to the empty seat carriage on a company airplane, inclusive of guests who are often the company's customers.

Second, with respect to the working condition fringe exemption, we feel the technical explanation recognizes that for reasons of safety it seems necessary to require employees to use designated means of transportation. We agree that such use would be exempt from tax.

Some key employees are by company policy required to use company aircraft and where such written policy exists, the practice should be exempt from taxation.

Three, with respect to the de minimis fringes argument, we agree with the conclusion reached by the American Institute of Certified Public Accountants, in its 1979 study of fringe benefits. They found that the occupying of a seat on a corporate aircraft by an employee traveling on a personal business trip is at such negligible added cost that it is likely to be de minimis.

In all of the above, there is a common thread. Use of empty seat transportation on business aircraft is infrequent, it is random, it is tentative, it is subject to bumping and we feel that it is in no way a fixed benefit such as an insurance program.

We would appreciate the opportunity to furnish an options paper to the subcommittee because we feel that there are areas which are not addressed in the proposed bill. We would like to furnish a paper which contains certain recommendations if the committee felt that that would be useful.

We would focus not only on the occasional empty seat practice, but that of spouses and other family members and we would very much appreciate the opportunity to address personal use of the business aircraft.

We thank you very much for the opportunity to be here and I certainly will attempt to answer any questions you may have.

Mr. JENKINS. Thank you, Mr. Winant.

[The prepared statement follows:]

## STATEMENT OF JOHN H. WINANT, PRESIDENT, NATIONAL BUSINESS AIRCRAFT ASSOCIATION, INC.

### SUMMARY

1. The technical explanation of H.R. 3525 proposes that allowing an employee of a firm to use for personal purposes an otherwise empty seat on a company aircraft which is on a business mission should be a taxable benefit to the employee. NBAA disagrees with this proposal.

2. NBAA believes that "empty seat" transportation of employees on company aircraft complies with three of the exemptions from taxation enunciated in Section 2 of H.R. 3525:

*(a) No-additional-cost service.*—The added cost of using an otherwise empty seat on a company aircraft is non-existent. It meets the same terms and conditions by which the use of an otherwise empty seat on an airliner by an airline employee would be at "no substantial additional cost," according to the technical explanation and therefore non-taxable.

*(b) Working-condition fringes.*—The technical explanation recognizes that for reasons of safety it is sometimes necessary to require employees to utilize designated means of transportation, and such use would be exempt from tax. Some key employees are by company policy required to use company aircraft and where such written policy exists, the practice should be exempt from taxation.

*(c) De minimis fringes.*—NBAA agrees with a conclusion reached by the American Institute of Certified Public Accountants (AICPA) in its 1979 study of fringe benefits. AICPA found that the occupying of a seat on a corporate aircraft by an employee traveling on personal business is at such negligible added cost that it is likely to be de minimis.

3. NBAA feels that the burdens of keeping records to track accurately the use of "empty seat" transportation of employees would outweigh prospective tax revenue. Further, the association believes that making such carriage subject to taxable income to the employee would put the practice at odds with certain Federal Aviation Regulations (14 CFR 91) which prohibit the levying of any charges on employees or guests.

### STATEMENT

Mr. Chairman, I am John H. Winant, President of the National Business Aircraft Association, an organization representing over 2500 businesses who fly over 5000 aircraft in the normal conduct of their business or who are involved in the aviation and aerospace industry. We welcome the opportunity and privilege to come before you today to discuss H.R. 3525 and the general subject of fringe benefit taxation.

Regretfully, it is impossible to comply with the Subcommittee's instructions to identify the aggregate value and cost of the practice we wish to discuss today. Unlike the airlines, not-for-hire operators are not required by the government to list for public inspection numbers of seats filled and for what purpose. Consequently, no data base is in existence for us or for anyone else to use to comply with your request.

Mr. Chairman, we are concerned about certain parts of the bill and specifically, we refer to the technical explanation attached to your remarks as printed in the Congressional Record of July 12, 1983. In this explanation of the bill's provisions, it is stated that allowing an employee of a firm to take an otherwise empty seat on a company airplane or auto would be a taxable fringe benefit "even though the plane or automobile otherwise is making a trip on company business". It is further stated that such an occurrence "is not a service generally provided to customers in the specific trade or business of the recipients' employer in which the employee is at the time providing services". We disagree. There are many occasions in the corporate world where prospective customers travel as guests in a company plane or auto for reasons of efficiency, convenience and for making the most productive use of time. Also, many companies utilize their aircraft as a sales tool. An example of this activity would be transporting prospective customers to a company's various installations as a demonstration of resources. Foremost, however, we are concerned that a misconception exists with regard to the use and utility of aircraft engaged in business as well as the general nature and operational characteristics of business aviation.

Aircraft used in business aviation range from small, single-engine airplanes and helicopters used to travel comparatively short distances between a company's installations to a wide range of twin-engine, medium size turbine aircraft specifically designed for business use and even to refitted airliners used to transport corporate executives and employees to overseas worksites and business meetings. A company's decision to involve itself in corporate aviation is based on a resolve to maximize its transportation resources and seek new customers and expanded opportunities.

Company aircraft are business assets and are comparable to word processors, copy machines or WATS lines: tools a company employs to conduct its business. Just as these business tools are sometimes available to employees, so too are empty aircraft seats occasionally available to employees traveling on personal business.

Many companies have policies restricting employee guests on the aircraft to extraordinary circumstances such as family emergencies where the employee is unable, due to finances or airline constraints, to travel by other means on short notice. Such "mercy flights", or situations in which a seat might not be otherwise available, are also provided to non-employees such as cancer patients seeking treatment in distant, highly specialized hospitals and who lack the money for similar transportation. In fact, a formal organization exists specifically for the humanitarian purpose of locating empty seats on compatible corporate flights for use by cancer patients. This organization, known as the Corporate Angel Network, or CAN, has been in existence only a matter of months yet boasts of commitments by 184 corporations and is responsible for coordinating 65 successful flights to date.

With those points in mind, we wish to address three of the four types of exclusions from taxation as contained in Section 2 of H.R. 3525. These exclusions are; no-additional-cost service, working condition fringe and de minimis fringe. It is our belief that the provision of "empty seat" transportation to an employee on company aircraft qualifies under each and every one of these exemptions from taxation. We note the various examples of what would be considered excludable and non-excludable and wish to bring additional examples to the attention of this panel.

When considering no-additional-cost fringes, an example given was that of an airline employee obtaining a free seat on an employer's scheduled flight on a space available, stand-by basis. In this instance, "the service is provided at no substantial additional cost", to quote the technical explanation, since the seat would otherwise remain empty as an unsold seat. The cost of allowing an employee to occupy an otherwise empty seat on a company's aircraft is also non-existent as long as the seat would otherwise remain empty. Just as there is no additional cost to the airline, there is no additional cost to any other aircraft operator in this instance.

In the case of working-condition fringes, stated examples include the provision of a chauffeured limousine for reasons of security and safety. In many instances, corporate executives are required by company policy to travel in company-operated autos and aircraft as a means to counter threats to safety. Stockholders frequently expect and demand such security provisions. This exclusion should apply in cases where it is the company's written policy that certain employees travel on company aircraft for reasons of security and safety even though the travel is not always of a purely business nature.

Finally, in the case of de minimis fringes, we subscribe to the discussion found on pages 14 and 15 of the April 1979, study prepared by the American Institute of Certified Public Accountants (AICPA). Part of this discussion centers on an employee taking "a personal ride on an airplane flying primarily for business reasons". For purposes of valuation, the study maintains that, in such an instance "(i)ncome taxed to the employee is the lower of the employer's incremental cost or the third-party equivalent cost. The taxable amount, so computed, is likely to be exempt under the de minimis rules." We agree with the AICPA conclusion and in particular its explicit finding that the employer's incremental cost of providing this type of "filling an empty seat" transportation is so negligible that it likely is de minimis.

There are several additional points we would like to make as well as expand upon some already stated.

First, the occupying of a seat on corporate aircraft by an employee traveling on personal business is erratic, i.e., on a stand-by basis. Thus, the employee is always subject to bumping by a last minute change in the need for other employees to travel on business. Conversely, a seat may not become available until the last minute before a planned flight, the point being that such travel is subject to the daily needs of a company and is not an entrenched, fixed benefit comparable to health insurance, as an example.

Secondly, it should be emphasized both that there is no accurate data as to the extent of this practice and that NBAA's experience in observing it leads us to believe it is rarely employed. We therefore feel that any potential tax revenues to be obtained by treating the practice as a taxable fringe benefit would be negligible. Further, we are confident that the burdens associated with requiring companies to track, identify, compute and associate the incremental benefits as additional income on employees' W-4 forms would result in the costs to both taxpayers and the government exceeding any planned revenue. So, viewed from any aspect, the anticipation that significant potential tax revenue resides in this practice is empty, in our studied view.

Last, imputing a value to empty seats on non-commercial aircraft and imposing a tax on such activity, as a fringe benefit and as a taxable income, would be at variance with Federal Aviation Regulations found at 14 CFR Part 91 regarding not-for-hire operations of aircraft defined as large or turbine-powered. These regulations specifically address corporate aircraft operations and permit the carriage of employees or guests but "no charge of any kind may be made for the carriage." An operator who made a charge, even by imputation on the employees' W-4 forms, would find itself in violation of one Federal regulation as it seemingly attempts to comply with another.

As the foregoing demonstrates, we do not consider the taxation of personal, space-available travel on business flights as a fringe benefit to be a viable option for the Congress. Instead, we submit that such use properly belongs under the exclusions found in H.R. 3525. Consequently, we urge that appropriate language be added to the measure to provide a clear, statutory basis on which business aircraft operators may confidently pattern their operations. Should this panel desire, we stand ready to provide technical expertise and legal assistance in developing suitable legislation which takes the aforementioned concerns into account.

This concludes our testimony and we are prepared to answer any questions you may have. Thank you.

Mr. JENKINS. A member of the committee who is not present has requested that the Chair ask you a couple of questions which I will do at this time.

Aside from the matter of corporation guests using empty seats on a company aircraft, should Congress address the practice of purely personal use of a company airplane?

Mr. WINANT. We feel, sir, it would be most advantageous for the Congress to consider what to do, and I hope what to do in final terms, with the question of personal use of the aircraft. It is a very complex problem. Today it is subject to the Internal Revenue Service's interpretation and to a tremendously wide variance of practice between the various regions of the Internal Revenue Service. We have to recognize also that there are certain types of personal use which are required by stockholders where such relate to security and safety.

Finally, we recognize the case where an aircraft might on occasion be used for a purely personal reason of transportation and that there then exists the question of valuation of that transportation and the imputation to it of what would be the proper amount of tax.

We would like to see this cleared up. The kinds of interpertations being used today across the country and vary everywhere from the equivalency of first-class air fares to charter rates, to the application of what would be considered direct operating costs of the aircraft on the flight. The technical explanation of the bill in discussing the provision of automobiles provided to employees raises a very interesting new concept where an automobile would be used less than 85 percent on business transportation, then some taxable consequence might result.

We think that the 85–15-percent rule might well be measured against use of company aircraft and it is for those reasons among others that we would appreciate the opportunity to furnish to you an options paper. It would discuss the entire realm of personal use of aircraft which are owned by companies, and would, we hope, offer you some constructive suggestions on how it might be dealt with.

Mr. JENKINS. We would be delighted to have that information.

Second, a three-part question: Just exactly what is business aviation? How does this segment of the aviation community differ from the airlines and pleasure pilots? When you state that a company aircraft is just another tool a company employs, what type of tool are we discussing? Advertising tools? Management tools? Entertainment tools?

Mr. WINANT. The principal use of aircraft in business aviation is pure and simple. It is aimed at promoting the principal business purposes of the company. I think I can answer that portion of the question best in an exemplary fashion. Typical uses of a business aircraft would be to provide transportation on a random or even on a frequent shuttle-type basis between company plants and facilities.

Approximately 40 percent of all business aircraft flights are from or to communities which are not served by any of the air carriers. In that regard, business aviation fills a very distinct void. In other words, we provide an on-demand kind of transportation which is available exactly when it is needed to points where it is needed to carry out the business of the company.

With respect to the second part of the question, it seems to me that the company airplane is all of the above, if you will, sir, in your question, but it is in the most fundamental payoff terms a time machine. It is a tool which extends the use of productive time for company personnel and in the final analysis, time without any question is the most precious asset we have and the judicious and best use of it is served in a very, very exemplary way by business aircraft.

Mr. JENKINS. Thank you very much, Mr. Winant.

In the subcommittee press release announcing today's hearing, the chairman had asked any witnesses addressing a specific fringe benefit to identify the aggregate value and cost of the fringe benefit for the most recent taxable year and the terms on which it is offered. Could the members of the panel provide to the committee such data for the airlines, including what percentage of this is interline travel?

Mr. PHILION. May I begin, Mr. Chairman, with an answer. The short answer to the valuation question is it is impossible to provide the committee with a dollar value on the air transportation used for personal travel. As Congressman Anderson said this morning, and as some of my colleagues at this table today have indicated, what is the value of a personal use pass if you arrive at the airport to catch an 8 a.m. flight, you get on at 9 in the evening some 13 hours later? Or you are bumped en route? Or you change your mind and have to come home because you cannot complete your transportation?

It is rather difficult, if not impossible, to put a valuation on it. I can give you a measurement to some extent of the size of the personal use travel market if you wish to describe it as such. We have provided this information to the committee staff.

We transported in the U.S. airline industry last year about 293 million passengers. The number of airline employees traveling on personal use travel came to about 3½ million. That is about 1.3 percent of all passenger traffic by the U.S. airlines last year. They were airline employees traveling on personal business.

While we are a deregulated industry and have been since October 1978, we remain unique in several respects. One of the unique characters of air transportation today is its interline nature. Some 30 percent of all airline passengers travel on two or more airlines and that trend is generally the same in the personal use travel of our airline employees in traveling around the country.

I hope that answers your question. If there are other data that we have that we can furnish, we will be glad to do so.

Mr. **Jenkins**. The data that you have provided to the staff, may we make that a part of the record?

Mr. **Philion**. Yes.

Mr. **Jenkins**. Thank you.

[The information follows:]

*1982 airline statistics*

| | |
|---|---|
| Revenue passengers enplaned (millions) | 293.2 |
| Revenue passenger miles (billions) | 259.0 |
| Available seat miles (billions) | 429.0 |
| System load factor (percent) | 59.0 |
| Nonrevenue statistics (includes both business and personal use): [1] | |
| Total nonrevenue passenger miles (billions) | 15.6 |
| Total nonrevenue passenger miles as percent of revenue passenger miles | 6.0 |
| Total nonrevenue passenger miles as percent of total available seat miles | 3.5 |
| Load factor including total nonrevenue passenger miles (percent) | 62.5 |

[1] Nonrevenue passengers defined: Nonrevenue passengers are defined by the CAB regulations as being passengers not paying full tariff and authorized free or reduced rate travel under Section 403(b) of the Federal Aviation Act. Therefore, included in addition to airline employees traveling on business or personal use are travel agents, government employees such as postal inspectors, air traffic controllers and sky marshals, witnesses in airline related litigation, accident victims and their families, et cetera.

Assuming nonrevenue passengers have same ratio of enplanements to trip length (RPM)=883 miles per enplanement:

| | |
|---|---|
| Total nonrevenue passenger enplanements (millions) | 17.7 |
| As percent of revenue passenger enplanements | 6.0 |
| Estimated nonrevenue passenger enplanements airline employee personal travel (20 percent) (millions) | 3.5 |
| Estimated number of enplanements per trip (pass) | 2.5 |
| Estimated number of passes used in 1982 (millions) | 1.4 |
| Average per airline employee [1] | 4+ |

[1] Interline employee personal travel: In response to a survey of ATA members, airlines (8) representing 40 percent of industry employment reported an estimated 111,000 free and reduced rate interline tickets issued. Assuming the same level of usage by all 330,000 industry employees, total interline free and reduced transportation passes or tickets would approximate 250,000 to 300,000 or slightly less than one interline pass or ticket per employee for personal travel in 1982. Interline usage represents approximately 20 percent of all employee free or reduced rate personal travel.

Mr. **Jenkins**. Ms. Puchala.

Ms. **PUCHALA**. When you talk about the value of a space-available seat for any airline employee, you can look at the value of a confirmed seat for a paying passenger with all the promotional fares out there We have had spouse flying for free so certainly the value of that confirmed seat is free. In addition to that, one of our airlines has a notorious program of kids flying free for box tops. That is a confirmed seat, too.

So, certainly if you can get a confirmed seat for a box top, the value of a space-available seat is negligible.

Mr. **JENKINS**. Ms. Puchala, let me ask you a couple questions in addition to this.

You seem to indicate that the taxation of this fringe benefit would be a tax on commuting, is that correct?

Ms. **PUCHALA**. Yes.

Mr. **JENKINS**. You are aware, of course, that other taxpayers are not permitted to deduct commuting expenses, are you not?

Ms. **PUCHALA**. Yes.

Mr. **JENKINS**. But you think there is a distinct difference between someone who is transferred because of deregulation from Atlanta to Chicago and an automobile worker whose plant has closed down and who has been sent elsewhere?

Ms. **PUCHALA**. One of the things about deregulation is that the airlines do not necessarily encourage flight crews to relocate simply because we have a history of what we call "following the time." For instance, if I am based in San Francisco and there are so many schedules available for me in San Francisco this month, there is no guarantee of that next month, because of the new routes. I am going to be temporarily assigned to Chicago. So that means rather than physically moving to Chicago, the airline encourages me to commute, "to follow the time," and then the following month come back to San Francisco and "follow the time."

The airlines want us to be available in certain cities during certain months and I think that this practice has escalated since deregulation. It is not like somebody working in a plant where this week they ask you to work in Detroit and next week they ask you to work in Columbus, Ohio. They ask you to work in Ohio in a plant setting and temporarily transfer you for a month and pay your lodging expenses.

Mr. **JENKINS**. I think we would get into real difficulties if we based this entirely on the commuting argument. I think you would get into all sorts of difficulties with other types of commuting that may be treated differently.

Mr. **DUNCAN**. Would the chairman yield?

Mr. **JENKINS**. I would be happy to yield.

Mr. **DUNCAN**. Mr. Chairman, it would appear that the commuting issue is not only a convenience for the employee but also for the employer and I know of instances where employees are provided expenses for commuting to and from their work. I have one in mind, the Southern Railway in Knoxville. They transfer employees, run buses regularly to Etowah, Tenn., 60 or 70 miles away.

The TVA runs a bus, free bus every day from Knoxville to Chattanooga and one back to Knoxville. So there is a case of that, there are cases of small employers. I know of a service station that picks their employees up in the country and brings them into the city.

But it is paid for, and it is not just the airlines. I know the airlines, perhaps, do more so than others and I can understand how a lot of people would like to live in a place like Boston or somewhere else, rather than in the country. But it is something I think that we have to be very cautious about and very careful.

Mr. **Philion**. Could I intervene on this question, Mr. Jenkins?

Mr. **Jenkins**. Mr. Philion.

Mr. **Philion**. I think what we have to bear in mind is we are talking about a seat that would otherwise be empty. If you are raising questions about the broader issue of commuting and displacing a passenger who would otherwise buy that seat, I would take your point. Please note, though, that we are talking in all these cases of seats that otherwise are empty or would be wasted.

Mr. **Jenkins**. I have one further question, Ms. Puchala.

I know that some members of the committee have been receiving requests from your organization to oppose H.R. 3525. This seems to be a bit premature since the bill has not been drafted in final form.

Would you rather the moratorium expire so that you would be taxable on the full benefits or do you want us to take some action on this measure?

Ms. **Puchala**. We would prefer that you deal with it as we mentioned in our testimony. You will have to forgive us if we did jump the gun, maybe we are a little premature, but——

Mr. **Jenkins**. We may fix it where you like H.R. 3525, and you may have to have all the employees say, "Please support H.R. 3525."

Ms. **Puchala**. We recognize that, and we are willing to send out new post cards and you will be getting another flood of mail.

One of the things we have been dealing with is the fact that the airline employees in the industry have not been doing well under deregulation. The very thought now of an additional tax burden on us is not going to be very well received. Rather than take a chance, we decided we would show you how actively involved we are and how we are monitoring this situation.

Also, in dealing with the Internal Revenue Service, we have not been particularly successful. The Internal Revenue Service has been granting waivers to the funding in our retirement plans without the employees being informed either by the employer or by the Internal Revenue Service.

So I think there is a great deal of skepticism whenever we deal with the Internal Revenue Service.

Mr. **Jenkins**. Well, I would hope that the subcommittee would have an opportunity to work with you before we get to a full-fledged support or opposition situation. You will have ample time, in the event we can't draft a bill that you will support, to contact your organization. I think most of the members of the committee are flexible and want to be helpful. It may not be perceived by some members as the most receptive type of cooperation, if we get bombarded with mail before we start to draft a bill.

Thank you very much.

Do you have further questions?

Mr. **Duncan**. No, sir.

Mr. **Jenkins**. Thank you very much for your testimony.

Mr. JENKINS. Our next panel is the American Association of University Professors, American Council on Education, Association of American Universities, Association of Catholic Colleges and Universities, Association of Jesuit Colleges and Universities, and the National Association of Independent Colleges and Universities, Jeff Carr, vice chancellor and general counsel, Vanderbilt University, Nashville, Tenn.; William Collins, Ph. D., president, executive committee, Cornell University chapter, American Association of University Professors, Ithaca, N.Y.; Dr. G. N. Russell Smart, senior professor, department of chemistry, Muhlenberg College, Allentown, Pa.; and Ms. Joan Weber, Westminster, Md., student, American Univerity.

Mr. DUNCAN. Mr. Chairman.

Mr. JENKINS. Mr. Duncan.

Mr. DUNCAN. By request I would like to call to the attention of the committee another issue which involves universities and fringe benefits.

This is a provision of faculty housing, H.R. 677, which is introduced by Congressman Shannon and Congressman Conable, and which addresses the retroactive imposition of withholding tax liability on those universities providing faculty housing. The bill has been referred to this committee.

Representatives of the affected institutions have provided testimony for the hearing which I would like to ask be included in the record at this point.

Mr. JENKINS. Without objection.

[The information follows:]

## STATEMENT OF NANNERL O. KEOHANE, PRESIDENT OF WELLESLEY COLLEGE

This statement, which addresses the tax treatment of traditional faculty housing programs, is being submitted to the Select Revenue Measures Subcommittee of the House Ways and Means Committee by Nannerl O. Keohane, President of Wellesley College in Wellesley, Massachusetts, in connection with its consideration of the taxation of fringe benefits, in particular H.R. 3535.

This statement is submitted on behalf of Wellesley College, Amhearst College, Smith College, Wesleyan University and the following 14 educational associations:

American Association of State Colleges and Universities,
American Association of University Professors,
American Council on Education,
Association of American Universities,
Association of Catholic Colleges and Universities,
Council of Independent Colleges,
Federation of Indpendent Illinois Colleges and Universities,
Independent Colleges and Universities of Missouri,
National Association of College and University Business Officers,
National Association of Equal Opportunity in Higher Education,
National Association of Independent Colleges and Universities,
National Association of Independent Schools,
National Association of Schools and Colleges of the United Methodist Church, and
National Association of State Universities and Land-Grant Colleges.

Although this statement specifically discusses Wellesley's faculty housing program, it is generally applicable to all educational institutions that maintain traditional faculty housing programs.

### A. DESCRIPTION OF A TRADITIONAL FACULTY HOUSING PROGRAM

Wellesley operates a faculty housing program that rents houses and apartments to approximately 110 faculty members and certain administrators (for example, deans) and their families. The College maintains the program in order to have a substantial number of faculty members and administrators living on or near campus as part of an extended campus community, one that is conducive to informal interactions between faculty members and students. This sense of community has long been an integral part of the educational experience at Wellesley as a small, residential, liberal arts college. Yet whether an educational institution is located in a rural, suburban or urban setting a traditional faculty housing program, by creating a sense of collegiality among the faculty members and by encouraging student-faculty interaction outside the classroom, serves important educational goals of the institution.

During the 19th century Wellesley generally required all faculty members to live on campus. The President's report of 1900 stated that this practice "brought a body of intelligent and cultivated women into close contact with the student body, much to the advantage of the latter. The intercourse thus established has been helpful and beneficial in the highest degree. The spirit of unity and helpfulness has been largely fostered by this method of living . . ."

Although times have changed considerably since 1900, and Wellesley is no longer able to have its entire faculty residing on campus, the faculty housing program continues to serve our educational objectives by having substantial numbers of faculty living on or near campus.

Wellesley's housing program is accurately described as a "traditional" faculty housing program because it resembles the housing programs that exist and have existed for many years at numerous colleges, universities, and secondary schools across the country. Under Wellesley's program, housing is rented to faculty members at a substantial rent that reflects the College's cost of providing the housing, the educational purposes of the College served by having faculty members living on or near campus, and the value of the housing to the College's faculty members. No substitute cash living allowance is provided to employees who elect not to live in faculty housing.

### B. THE INTERNAL REVENUE SERVICE'S POSITION

Wellesley had maintained its housing program for decades, believing that the rents charged were reasonable to both the College and its faculty members.

The Internal Revenue Service, however, saw things differently. An IRS agent asserted that because Wellesley possibly could have rented its housing units on the open commercial market at higher rents, the difference between the higher theoretical "fair rental value" and the rent charged a faculty member constituted additional income to the faculty member. Furthermore, the agent maintained that this "income" to the faculty members constituted "wages" paid by Wellesley that were subject to retroactively-applied income tax withholding and social security taxes. The agent argued that Wellesley should have withheld these taxes during years extending back to 1974. The position of the agent was incorporated in formal action by the IRS at the end of 1981 when the IRS National Office issued two technical advice memoranda that treated traditional faculty housing programs at Amherst and Wesleyan as giving rise to retroactive withholding tax liability beginning in 1973 (Technical Advice Memoranda No. 8213005 and No. 8219001).

### C. WHY THE IRS POSITION IS INEQUITABLE AND UNPRECEDENTED

It is our belief that the IRS position is both inequitable and unprecedented for several reasons, three of which will be touched upon in this statement. First, the value of faculty housing cannot be measured simply by reference to the commercial rental market. Second, the IRS position is contrary to the Supreme Court's holding in *Central Illinois Public Service Company* v. *United States*, 435 U.S. 21 (1978). Third, the IRS action appears to violate congressional intent in passing Public Law 95-427, the "fringe benefit moratorium". Each of these reasons will be discussed in turn, followed by a proposed legislative solution to this problem.

#### *1. Valuation of faculty housing*

The IRS maintains that the value of Wellesley's faculty housing market must be measured purely by reference to the commercial rental market. Wellesley maintains, however, that the value of faculty housing must be measured with reference to: (i) the educational goals of the College served by the housing program, (ii) the value of the housing to the College's faculty members, and (iii) the College's cost of maintaining the housing.

It is not relevant to ask what a business executive would be willing to pay to live in Wellesley College housing because Wellesley is not a commercial landlord. Wellesley maintains its faculty housing program to further its educational goal of creating an extended campus community and not as a means of raising money. As is discussed below, if Wellesley were to change its policy and rent its housing to the highest bidder the result would be the destruction of its faculty housing program, at great educational cost to the College.

Instead of referring to the commercial market, the value of faculty housing should be measured with reference to what is in fact the relevant market—the College's employees. The College has attempted to set its rent at a level that is high enough to recover most or all of its costs in providing the housing and yet low enough to enable faculty members to live in the housing. If the College raised its rents substantially beyond the normal adjustment for inflation, most or all of our faculty members would move to other towns where they would be able to rent housing at a lower price. This would create a paradoxical situation in which the Wellesley College campus, one of the important reasons that property values are so high in the Town of Wellesley, would become responsible for driving our faculty members out of town.

There are a number of cases in which courts have held that the value of property or services received by an individual, and included in his income, should be measured with reference to the value to the recipient and not to some theoretical fair market value. For example, in *Reginald Turner,* 13 T.C.M. 462 (1954), the court dealt with taxpayers who had won a free trip to South America and concluded that the trip was not worth its full retail value to them because they might well not have chosen to provide themselves with an item of such value. Faculty members who are given the opportunity to rent housing on or near campus should similarly not be subjected to taxation based on the value of the housing to some abstract third party. Rather, the value of the housing to the faculty member should be given primary attention.

A further reason why it is unreasonable for the IRS to refer only to the commercial rental market is that the IRS has itself taken a contrary administrative position on several occasions. The IRS in those instances has stated that the value of a particular fringe benefit is the employer's cost of providing the benefit rather than a theoretical fair market value. For example, in Technical Advice Memorandum No. 7740010, dated June 30, 1977, the IRS concluded that "the value of the [cafeteria] meals [furnished to employees] to be included in gross income *is determined by the cost* incurred in furnishing the meal less the amount charged for the meal" (emphasis added).

In light of the unique situation presented by faculty housing programs, case precedent, and the IRS administrative position discussed above, it seems clear that the "value" of faculty housing must be measured not with reference to an abstract commercial market, but to the educational purposes served by the housing program, the value of the housing to the faculty members, and the educational institution's cost of providing the housing.

*2. Central Illinois*

An employer is not required to withhold taxes from all of the income that is received by an employee, but only from the "wages" that he pays to the employee. The term "wages" is defined in section 3401 of the Internal Revenue Code, with regard to income tax withholding, as "remuneration for services." A similar definition is found at section 3121 with regard to social security, or "FICA" (Federal Insurance Contributions Act), taxes.

In 1978 the Supreme Court held in the *Central Illinois* case, cited above, that a taxpayer/employer was not liable for withholding tax on the payment of lunch reimbursements to employees even though such payments clearly constituted taxable income to the individual recipients (because they were not excludable under Section 119[1] of the Internal Revenue Code). The Supreme Court concluded that the taxpayer had no duty to withhold because its liability was not "clearly defined" and because an employer should not be a guarantor for the payments of its employee's tax. In its decision, the Supreme Court rejected the argument made by the IRS that an item which is income to the employee because it is outside the exclusion of Section 119 is also automatically "wages" (i.e., "remuneration for services") for withholding purposes.

As is discussed further below, no Internal Revenue Code section, regulation, ruling, or decided case has ever stated or held that participation in a traditional faculty housing program constitutes "wages" subject to withholding. In light of this absence of precedent and the fact that traditional faculty housing programs have operated for decades without objection by the IRS, educational institutions can hardly be said to have a "clearly defined" withholding obligation. Moreover, substantial case law (cited by the Supreme Court in *Central Illinois*) has held that an employer is not required to withhold where an item is provided for a dominant business purpose other than compensating employees. In this case, Wellesley's purpose in maintaining the faculty housing program is educational—to create an extended campus community with regular interchange between faculty and students. *Central Illinois* therefore precludes the assessment of retroactive withholding taxes against educational institutions maintaining traditional faculty housing programs.

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[1] Section 119 provides an exclusion from income for meals or lodging furnished to an employee (i) for the convenience of the employer, (ii) on the business premises of the employer, and (iii) (in the case of lodging) where the employee is required to accept the lodging as a condition of employment.

In Revenue Procedure 80-53, 1980-2 C.B. 848, the Internal Revenue Service published its response to the *Central Illinois* decision. The Revenue Procedure generally provides that withholding will not be required where (a) the employer had a "reasonable basis" for its belief that the benefits should not be considered remuneration for services and (b) no statute or other legal authority specifically required withholding.

The "reasonable basis" aspect of the Revenue Procedure 80-53 test is clearly satisfied by Wellesley because of the reasons discussed in section C.1 above, the lack of any decided cases requiring withholding on account of traditional faculty housing programs, the fact that our program and similar programs across the country have existed for decades without objection by the IRS, and the substantial case law supporting non-withholding in view of Wellesley's business, i.e. educational, purpose in maintaining the housing program.

The IRS, however, has asserted that faculty housing programs such as Wellesley's fail the other part of the Revenue Procedure 80-53 test—that no statute or other legal authority required withholding. This position of the IRS was announced in the technical advice memoranda concerning Amherst and Wesleyan and is based on an unusual and unsupported extension of an argument first officially stated by the IRS in 1981 in Revenue Ruling 81-222, 1981-2 C.B. 205. Revenue Ruling 81-222 indicates that meals and/or lodging which are not excluded from taxable income by Section 119 of the Internal Revenue Code automatically constitute "wages" subject to withholding, without regard to the usual and fundamental question in determining "wages"—whether such items were provided as "remuneration for services."

The IRS contended in the technical advice memoranda that the institutions did not satisfy the requirements of Revenue Procedure 80-53 on the theory that a specific regulation—Reg. Section 31.3401(a)-1(b)(9)—treated the housing in question as "wages." That regulation, however, simply states the obviously sound rule that amounts excluded from income under Section 119 will not be treated as "wages" subject to withholding; it in no way suggests that other meal and lodging items (assumed not to be covered by Section 119) are necessarily "wages" without regard to the question of whether they constitute "remuneration for services" in the first place. In the technical advice memoranda, the IRS said that Revenue Ruling 81-222 "restated" this "principle."

The IRS position, and the application of Revenue Ruling 81-222 to traditional faculty housing programs, is inconsistent with the Supreme Court's *Central Illinois* decision. The *Central Illinois* case itself involved a meal and lodging item—a meal allowance—found not to qualify for the Section 119 exclusion. If the IRS' rationale in Revenue Ruling 81-22 were applied to *Central Illinois* one would conclude that because the lunch reimbursements did not satisfy section 119 they necessarily constituted wages subject to income tax withholding. And yet the Supreme Court's holding was exactly the opposite: *despite* the fact that the lunch reimbursements were not excluded from "income" by Section 119, they did not fall within the "much narrower" category of "wages." In any event, even if the position stated in Revenue Ruling 81-222 were correct (and we think it is entirely incorrect as applied to traditional faculty housing programs), it would hardly affect an institution's "reasonable basis" for not withholding during years prior to 1981.

It should be noted that Revenue Ruling 81-222 need not be regarded as incorrect if it is properly limited to the factual situation it describes—namely, the provision of *free* meals or housing. The provision of free meals or housing would arguably involve remuneration for services because it would relieve the employees from a personal expenditure they would otherwise have to incur. This is not the case with respect to traditional faculty housing programs charging rents reflecting the value of housing to the employees.

### *3. The fringe benefit moratorium*

In 1978, in response to Treasury's attempts to expand broadly the taxation of fringe benefits, Congress enacted the "fringe benefit moratorium" (Public Law 95-

427), prohibiting the issuance of new regulations in the fringe benefit area. Moreover, Congress made it clear in legislative history that the moratorium "would prevent the IRS from deviating from the present administration of the tax laws as they concern the taxation of fringe benefits as compensation." House Report No. 95-1232. The Report states that the moratorium was imposed because Congress recognized that the lack of uniformity in the fringe benefit area led to inequitable distinctions between taxpayers receiving similar benefits, difficult decisions as to an employer's obligation to withhold taxes, and difficult valuation problems regarding fringe benefits. The fringe benefit moratorium has been extended twice by Congress, most recently by Public Law 97-34, § 801, and remains in effect through December 31, 1983.

The fringe benefit moratorium applies to traditional faculty housing programs because such programs have not previously been challenged by the IRS, because there is no direct legal precedent for imposing additional employment taxes on institutions maintaining such programs, and because the IRS attack on faculty housing programs represents a depature from the cost measure of value which the IRS itself has utilized in other cases.

The IRS has argued on several occasions, such as in the technical advice memoranda concerning Amherst and Wesleyan, that there are cases that establish a precedent for taxing traditional faculty housing programs. For example, *Benninghoff* v. *Commissioner,* 614 F. 2d 398 (5th Cir. 19800) aff'g 71 T.C. 216 (1978) (free housing provided to Panama Canal Zone policeman); *McDonald* v. *Commissioner,* 66 T.C. 223 (1976) (lodging rented to business executive in Tokyo). Those cases do not bear directly on traditional faculty housing programs for several reasons.

These cases, which interpret section 119 of the Internal Revenue Code, do not affect the applicability of the fringe benefit moratorium. It is not sufficient for the IRS to argue that because it has taxed isolated business executives who have received free or discount housing in compensatory circumstances there is a precedent for taxing faculty housing. Traditional faculty housing programs have a completely different purpose from typical corporate perquisites, especially in light of the substantial rents charged and the educational objectives served by the programs.

The IRS also cites *Goldsboro Christian Schools, Inc.* v. *United States,* 78-1 USTC 9191 (E.D.N.C. 1977) and *Bob Jones University* v. *United States,* 670 F. 2d 167 (Ct. Cl. 1982) for the proposition that there is a precedent for taxing faculty housing. *Goldsboro* and *Bob Jones* involved the provision of *free* housing to employees at institutions that the Supreme Court recently found not to be tax exempt because of their policies of racial discrimination. Neither *Goldsboro* nor *Bob Jones* support the IRS's position with regard to traditional faculty housing programs. Those cases are clearly distinguishable from traditional housing programs where resasonable rents are charged that reflect the eductional institution's costs and the value of the housing to the employees. In *Goldsboro* and *Bob Jones* the housing was provided free of charge to the employees, the housing was obviously provided at substantial expense to the employer, and in some instances employees who did not live in the free housing were offered a cash stipend. The employees in those cases also received other substantial benefits such as free utilities, free food, free medical care and free insurance. In these circumstances, the provision of free housing and other benefits necessarily relieved the employees of personal expenses and thus involved taxable compensation. Therefore, the result in *Bob Jones* and *Goldsboro,* although not surprising, has no direct bearing on the applicability of the fringe benefit moratorium to a tax-exempt educational institution which charges reasonable rents reflective of costs, and which does not offer a cash alternative.

Congress recognized when it passed the fringe benefit moratorium that Section 61 of the Internal Revenue Code and the Regulations thereunder provided on their face for the taxation of every item provided in kind by an employer at less than its value. However, Congress also recognized that despite this principle the IRS in fact has not challenged certain fringe benefit practices, and the moratorium was intended to maintain that status quo until Congress itself could review the entire fringe benefit area. See House Report No. 95-1232. Thus, for example, while the IRS would tax a top saleman who was awarded an airline trip to Hawaii by his employer, the IRS had not taxed widespread programs for providing free or virtually free airline travel to flight attendants. The latter benefit, which involves special circumstances such as the fact that the employer did not incur any subtantial marginal costs, is thus protected by the fringe benefit moratorium while the former benefit is not. Just as the flight attendant who receives free travel is distinguishable from the saleman who receives free travel as bonus compensation, traditional faculty housing programs are distinguishable from housing provided in the business context or provided free of charge at Bob Jones University or at Goldsboro Christian Schools, Inc. Indeed, traditional faculty housing programs are not unlike the provision of free travel to flight attendants in that in both cases the benefit is provided at little or no unreimbursed cost to the employer.

Finally, as noted above, the IRS itself has applied a cost measure for so-called fringe benefits, specifically with respect to cafeteria meals. To seek to apply a commercial market value measure to traditional faculty housing programs is therefore a change in IRS practice which Congress sought to prevent when it enacted the fringe benefit moratorium.

### D. PROPOSED LEGISLATIVE SOLUTION

We propose that Congress remedy the inequity created by the IRS' attempts to override *Central Illinois* and the fringe benefit moratorium and to collect retroactive withholding taxes from educational institutions maintaining traditional faculty housing programs.

First, for the future, Congress should make it clear through legislation that traditional faculty housing programs do not give rise to taxable income or wages subject to withholding as long as the institution's costs are recovered. We propose that H.R. 3525 be amended to provide such a solution, just as the bill currently provides special rules for tuition remission, automobile salesmen and employee parking. Such amendment would exclude the value of "qualified campus lodging" from gross income. Qualified campus lodging would mean lodging on or near campus furnished at or above cost by an educational institution to an employee, his spouse or any of his dependents. If the rent charged is less than the institution's cost of providing the lodging then the difference between the cost and the rent would constitute income to the employee.

Second, as to the past and present, Congress should clarify the application of the fringe benefit moratorium to traditional faculty housing programs, so as to prevent the imposition of retroactive withholding taxes. H.R. 677, introduced earlier this year by Congressmen Shannon and Conable, and now pending before this Subcommittee, would have this effect (providing for tax only in certain instances with respect to excess costs not fully recovered by rents). Alternatively, we propose that a faculty housing amendment to H.R. 3525 deal with prior years.

Finally, if the fringe benefit moratorium is extended beyond December 31, 1983 in order to provide additional time for Congress to reach a comprehensive resolution of the fringe benefit area, Congress should make it clear that the moratorium applies to traditional faculty housing programs, both as to the past and for any extension period.

### E. REVENUE IMPACT

I know that this hearing is intended both to help clarify the fringe benefit area and to uncover new sources of tax revenues which may be available to respond to our growing federal deficit. Traditional faculty housing programs, however, do not provide a source for revenue. The alternative for educational institutions is to sell off the housing; the resulting cost to the Federal Government from homeowner deductions for mortgage interest and property taxes would in all likelihood exceed the amount being sought by the IRS in these cases.

### F. CONCLUSION

I urge you, on behalf of Amherst College, Smith College, Wellesley College, Wesleyan University and the many institutions and individuals represented by the educational associations listed above, not to allow this inequitable situation created by the Internal Revenue Service to continue. Wellesley, in its effort to provide excellence in all aspects of education, has maintained its faculty housing program for almost 100 years. The continuing need for excellence in American education, an excellence that must exist both within and without the classroom, calls for your support of such programs rather than for their destruction at the hands of the Internal Revenue Service.

**Mr. Duncan.** And the statement I have just made.

**Mr. Jenkins.** Without objection.

[The information follows:]

Mr. Chairman, there is another issue which involves universities and fringe benefits that I believe should be brought to the committee's attention at this time. This is the provision of faculty housing. H.R. 677, introduced by Congressmen Shannon and Conable, which addresses the retroactive imposition of withholding tax liability on those universities providing faculty housing, has been referred to this committee.

Representatives of the affected institutions have prepared testimony for this hearing and I would like to ask that it be included in the record. It does not appear that there is any significant difference between the faculty housing issue and tuition remission in relation to the "general rules" contained in H.R. 3525.

Mr. JENKINS. I want to thank this panel for appearing before the subcommittee today and I think we will commence with Ms. Weber.

I know the greatest number of people are in your age group so I do not want to offend that particular group of people. I will start with you.

## STATEMENT OF JOAN WEBER, STUDENT, AMERICAN UNIVERSITY, ON BEHALF OF AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS, AND TUITION EXCHANGE, INC.

Ms. WEBER. I am Joan Weber. I am entering my second year of study at the American University in the College of Arts and Sciences and the School of Government and Public Administration.

I am here to give input against inclusion of the tuition exchange scholarships as a taxed fringe benefit. I am a student at the university only because of the scholarship. My father is a full-time professor at the school, Western Maryland College. Under the tuition exchange program, my father became eligible to participate after 5 years of full-time service to the college. During my junior year of high school I began my search for a college. I limited myself to the colleges and universities that participated in the tuition exchange program.

My goal was to find a fairly large school with access to a city. I was fortunate to find American University. Without a tuition exchange scholarship, I would have been limited to attending Western Maryland College, which maintains a tuition remission program.

Since 1969 I have literally grown up on the campus of Western Maryland College as the daughter of a faculty member. I know most of the faculty by their first names. As a political science major at Western Maryland College, I would have been placed in my father's own department, where he serves as chairman. There are only three members of the department, including my father.

At American University I have the freedom and clear conscience to pursue any area of study that I wish. American Univerity considers the city of Washington as an extension of its classrooms through internships and cooperative study programs. The opportunities for a political science/history major at American University appear endless.

All across the Nation colleges and universities are being forced to raise their tuitions. American University is no exception. Without my tuition exchange scholarship it would be impossible for me to attend a major university, particularly one in Washington.

Under the guidelines of the tuition exchange scholarship program at Western Maryland College, American University has been permitted to withdraw some of my scholarship funds. Therefore, I must now pay partial tuition and room and board in full. I have worked both of the summers while at American University, and I have maintained a job during the school years. Through the combination of the tuition exchange scholarship and the money I have earned, I am able to attend a well-established independent university that provides both the type of curriculum and quality education I desire.

I appreciate this opportunity to appear today in support of a provision in H.R. 3525 that would permit tuition exchange scholarships to remain as nontaxable.

Mr. **Flippo.** Thank you, Ms. Weber.

[The prepared statement follows:]

## Statement of Joan Weber, Westminster, Md., Student at American University

### SUMMARY

I attend American University under the Tuition Exchange program. My father, Professor Robert J. Weber, is chairman of the Department of Political Science at Western Maryland College. Western Maryland College and American University participate in Tuition Exchange, Inc.

*Scholastic and personal benefits of tuition exchange*

1. Tuition Exchange has provided me with the opportunity to attend American University rather than Western Maryland College, which has a tuition remission program.
2. Since my father has been on the faculty of Western Maryland College since 1969, the professors on the College faculty are long time friends of our family.
3. I wish to be a political science/history major. At American University I have complete independence to pursue the area of study I desire. Since my father is chairman of the political science department at Western Maryland College, I would be limited in the selection of my major field of study.
4. Attending American University permits the city of Washington to be part of my campus because internships and cooperative study programs are available in the city.

*Financial benefits of tuition exchange*

1. Without Tuition Exchange I could not afford to attend American University, which has an excellent educational program and is located in a city with numerous job opportunities.
2. Since the Tuition Exchange scholarship covers only partial tuition, I have the responsibility to earn the remaining funds. These remaining costs are high enough that I feel I am working my way through college.

### STATEMENT

My name is Joan Weber. I am in my second year of studies at American University under a Tuition Exchange scholarship. This scholarship is available to me because my father, Dr. Robert J. Weber, has been a full-time professor of political science at Western Maryland College in Westminster, Maryland, since 1969.

Under the Tuition Exchange program in effect at Western Maryland College, my father became eligible to participate after five years of full-time service at the college. In 1980 my brother David began his studies under a Tuition Exchange scholarship at Muhlenberg College in Allentown, Pennsylvania. It was through his search for schools that I became aware of the Tuition Exchange program.

During my junior year of high school I began my search for a college. I limited myself to colleges and universities that participate in the Tuition Exchange, Inc. program. My goal was to find a fairly large school with access to a city. I was fortunate to find American University. Without a Tuition Exchange scholarship, I would have limited to attending Western Maryland College, which maintains a tuition remission program.

Since 1969 I have literally grown up on the campus of Western Maryland College as the daughter of a faculty member. I know most of the faculty by their first names. As a political science major at Western Maryland College, I would have been placed in my father's own department, where he serves as chairman. There are only three members of the department, including my father.

At American University I have the freedom and clear conscience to pursue any area of study that I wish. American University considers the city of Washington as an extension of its classrooms through internships and cooperative study programs.

The opportunities for a political science/history major at American University appear endless.

All across the nation colleges and universities are being forced to raise their tuitions. American University is no exception. Without my Tuition Exchange scholarship it would be impossible for me to attend a major university, particularly one in Washington.

Under the guidelines of the Tuition Exchange scholarship program at Western Maryland College, American University has been permitted to withdraw some of my scholarship funds. Therefore, I must now pay partial tuition and room and board in full. I have worked both of the summers while at American University, and I have maintained a job during the school years. Through the combination of the Tuition Exchange scholarship and the money I have earned I am able to attend a well-established independent university that provides both the type of curriculum and quality education I desire.

I appreciate this opportunity to appear today in support of a provision in H.R. 3525 that would permit tuition exchange scholarships to remain as non-taxable.

Mr. **Flippo**. Mr. Carr.

## STATEMENT OF JEFF CARR, VICE CHANCELLOR AND GENERAL COUNSEL, VANDERBILT UNIVERSITY, NASHVILLE, TENN., ON BEHALF OF NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES, AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS, ASSOCIATION OF AMERICAN UNIVERSITIES, ASSOCIATION OF CATHOLIC COLLEGES AND UNIVERSITIES, ASSOCIATION OF JESUIT COLLEGES AND UNIVERSITIES, AND AMERICAN COUNCIL ON EDUCATION

Mr. **Carr**. Mr. Chairman and members of the Ways and Means Committee; I am Jeff Carr, vice chancellor for university relations and general counsel of Vanderbilt University. I speak today on behalf of the National Association of Independent Colleges and Universities, the American Association of University Professors, the Association of American Universities, the Association of Catholic Colleges and Universities, the Association of Jesuit Colleges and Universities, and the American Council on Education, whose combined membership includes more than 2,000 independent and public nonprofit colleges and universities.

The tax treatment of scholarship programs for the children of faculty and other employees of colleges and universities is important to educational institutions, but the real beneficiaries of these programs are the students who receive scholarships provided by them.

We are pleased that H.R. 3525 recognizes that programs of tuition reduction offered at the home institution are scholarships, but believe also that tuition exchange and off-campus tuition grant programs for children of faculty and staff should be defined as scholarships.

There are important policy reasons for continuing to view all three forms of tuition assistance as scholarships, and a policy upheld under the legislative history, letter rulings, and audits over the past 30 years that has never distinguished among these three program forms should not be overturned.

These scholarship programs have the same goal as other kinds of financial aid: to assist those who are able and willing to realize their goal of a college education. An extremely high proportion of the children of college faculty members attend college. Scholarship programs for these students provide a small but important decrease in the demand for Government-supported financial aid. Taxation of these scholarships will decrease their value in real dollars-and-cents terms, leading students now taking advantage of such programs to apply for college work-study or a guaranteed student loan and enlarging the need for appropriations to these programs. In contrast to other forms of student assistance, this one has involved no appropriations by the Government, no dependence on private gifts, and an economical, marginal cost to colleges and universities.

Vanderbilt University has provided tuition discounts to children of faculty members from the beginning of its existence in 1875. Since that time, the amount of the discount has varied, but the university has consistently provided tuition discounts for children of faculty and staff. Tuition scholarships at other institutions for faculty children denied admission to Vanderbilt were instituted as increased demand for places brought about increased selectivity in admission and to provide equity for faculty children who do not qualify for admission at Vanderbilt.

Such scholarship programs exist at many universities, and many of these programs, like Vanderbilt's, pre-date the enactment of the income tax. The definition of these programs, and the particular combination offered, varies from institution to institution.

Most plans, like Vanderbilt's, were established so that the children of faculty members—traditionally paid lower salaries than persons of comparable educational attainment receive in industry and in the other professions—would not be deprived of a college education because of the career choice of their parents. Last year, at Vanderbilt, 592 students received discounts under this program. 197 of these attended institutions other than Vanderbilt.

In these days when many young scholars are drawn to other, more lucrative careers, tax-free tuition scholarships make it possible for those with children to remain in higher education without precluding basic educational opportunity for their children.

These are unique programs, not available in other employment settings, and their importance increases each year as costs of college rise. Taxing these scholarships would not negate their value, but in many marginal situations, when an institution competes with industry for highly skilled people, it may result in the loss of a teacher and his or her talents.

Estimates indicate that the revenue realized from the taxation of these scholarships would be small, perhaps only $5 million. We suggest that the value to the Nation—measured concretely by productivity and taxable income of the citizens educated under these plans—is many times greater.

It is wise to encourage through the tax laws what is a simple arrangement, now working well, that benefits a small but significant number of college students. This arrangement gives valued encouragement and incentive to the large numbers of Americans employed in higher education, and we commend to you a continuation of the current treatment as nontaxable scholarships of all three forms of scholarships for children of faculty and staff.

Thank you.

Chairman STARK. Thank you very much, Dr. Carr.

[The prepared statement follows:]

## Statement of Jeff Carr, Vice Chancellor and General Counsel, Vanderbilt University on behalf of American Association of University Professors, American Council on Education, Association of American Universities, Association of Catholic Colleges and Universities, Association of Jesuit Colleges and Universities, and National Association of Independent Colleges and Universities

Mr. Chairman and Members of the Ways and Means Committee, my name is Jeff Carr. I am Vice Chancellor for University Relations and General Counsel of Vanderbilt University. I speak today on behalf of the National Association of Independent Colleges and Universities and the American Council on Education, and the other associations listed on the cover sheet, who together include more than 2,000 independent and public non-profit colleges and universities.

The tax treatment of scholarship programs for the children of faculty and other employees of colleges and universities is important to educational institutions, but the real beneficiaries of these programs are the students who receive scholarships provided by them.

Vanderbilt University has provided tuition discounts to children of faculty members from the beginning of its existence in 1875. At first, other categories of students were also granted tuition discounts, such as children of clergy and of school teachers. At the turn of the century, the policy was formalized, restricted to children of faculty, and reduced to one-half tuition. Since that time, the precise amount of the discount has varied, but the University has consistently provided specified amounts of tuition discounts for children of faculty and staff.

Such scholarship programs exist at many universities, and many of these programs, like Vanderbilt's, pre-date the enactment of the income tax. These plans were established so that the children of faculty members—traditionally paid lower salaries than persons of comparable educational attainment receive in government or business—would not be deprived of a college education because of the career choice of their parents. Thus, there were established administratively simple scholarship programs, growing out of institutional self-interest and self-help.

The characterization of such programs as tax-free scholarships was affirmed by both the House and Senate tax-writing committees in the Committee Reports that accompanied the 1954 tax bill. We are pleased that H.R. 3525 recognizes that programs of tuition remission offered at the home institution are scholarships, but disgree with the characterization of tuition exchange programs as taxable fringe benefits.

The major source of data on programs of tuition remission is the National Center for Education Statistics—Higher Education General Information Survey (HEGIS) prepared each year by the government.[1] According to HEGIS, 27,974 students received tuition remission benefits in 1981-82 at 1,033 colleges and universities. 246 public colleges, and 787 nonprofit independent colleges (representing 78 percent of all private colleges with enrollments above 500) were involved. While the majority of students and institutions offer such a program only at the home campus, approximately 4,300 students are eligible for portable tuition grant programs offered by 218 colleges and universities. This number has remained fairly stable over the last two decades. Under the terms of H.R. 3525, the financial assistance provided to this group of young Americans would be terminated at the end of the next academic year.

There are important policy reasons for continuing to view all three forms of tuition remission—on-campus, tuition exchange, and tuition grant—as scholarships. No compelling argument has been advanced to justify the overturn of a policy upheld under the legislative history, letter rulings, and audits over the past thirty years that has never distinguished among program forms.

The definition of these programs, and the particular combination offered, varies from institution to institution. In fact, many colleges and universities offer a combination of programs.

A quotation from the Vanderbilt University Faculty Manual describes the basis for Vanderbilt's tuition discounts:

"The policy on tuition discounts is based upon the premise that Vanderbilt's educational resources and facilities should be available to the dependent children of full-time primary-based faculty, with distinctions on the basis of rank and service; and that such children who are not qualified for admission to Vanderbilt shall be recompensed with comparable support toward the baccalaureate degree at accredited, four-year colleges or universities elsewhere."

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[1] It should be noted that HEGIS data are limited to faculty and their dependents. Therefore, there is likely to be some undercount. Further, the data necessary to answer many of the questions raised by staff as to program restrictions and eligibility requirements have never been collected. Arrangements have recently been made to conduct a survey this fall that should fill in many of the current gaps in knowledge.

At Vanderbilt, dependent children of senior faculty and staff are eligible for a discount that amounts to 94 percent of the current charge for basic tuition. Children of other faculty and staff are eligible for a discount of 47 percent. Discounts are confined to undergraduate programs leading to the bachelor's degree. If a child is refused admission to Vanderbilt for academic reasons, Vanderbilt will pay the actual tuition charged at another accredited institution offering work toward a baccalaureate degree, up to the amount that would have been received at Vanderbilt.

Tuition scholarships at other institutions for faculty children denied admission to Vanderbilt were instituted as increased demand for places brought about increased selectivity in admission in the late 1950s. The portability feature of the plan exists to provide equity for faculty children who do not qualify for admission to Vanderbilt.

For other institutions a different weighing of factors produced a different result. For example, some colleges that aim at maintaining a very diverse student body actively discourage tuition remission recipients from attending the home institution. These colleges reason that getting away from home and gaining exposure to a new environment is integral to the educational experience. Other colleges that have adopted portable programs worry that tuition remission students on small campuses may feel awkward taking courses from colleagues of their parents. Correspondingly, faculty members with the offspring of their colleagues enrolled in their courses may also feel uncomfortable. In addition, the home campus may not offer the specific course of study desired by the student, or may limit enrollment eligibility to single sex.

In all of these scholarship programs for the children of faculty and staff at colleges and universities, the goal is the same as other kinds of financial aid: to assist those who are able and willing to realize their goal of a college education. An extremely high proportion of the children of college faculty members attend college. Scholarship programs for these students provide a small but important decrease in the pressure for government-supported financial aid. Taxation of these scholarships will decrease their value in real dollar-and-cents terms, leading students now taking advantage of such programs to apply for College Work-Study or a Guaranteed Student Loan, and enlarging the need for appropriations to these programs.

Taxing these scholarships would not negate their value, but in many marginal situations, when an institution competes with industry for talent, it may result in the loss of a teacher and his or her talents. In these days when many young scholars are drawn to other, more lucrative careers, tax-free tuition scholarships make it possible for those with children to remain in higher education without precluding basic educational opportunity for their children.

Further, these programs give colleges and universities a competitive edge in student recruitment. The children of its own faculty or faculty of other institutions are among the best-prepared in any applicant pool. Independent universities in particular increasingly find themselves in competition with excellent public institutions for these able young people. Tuition discounts are one additional tool available to recruitment and admission officers in seeking the best students.

Perhaps the best reasons for leaving the status quo in place has to do with public policy. Estimates indicate that the revenue realized from the taxation of these scholarships will be small, perhaps less than $5 million. We suggest that the value to the nation—measured concretely by productivity and taxable income of the citizens educated under those plans—is many times greater.

The effects of taxation of these programs are not known. There is an advantage—which has been encouraged by tax policy—of having many institutions engaged in offering these programs. Curtailment in the numbers of programs as a result of taxation may leave them in place only at larger, wealthy institutions, thus diminishing these student's options.

But even if there is no substantial impact—and the fact that the impact is not known is enough to recommend against taxation of these programs—it may be wise public policy to encourage through the tax laws a simple arrangement, now working well, that benefits a small but significant number of college students. It gives valued encouragement and incentive to the large numbers of Americans employed in higher education. It is consistent with this administration's non-governmental approach to educational and social policy-making.

We recognize the power of Congress to tax the scholarships provided through tuition remission and, indeed, almost anything it chooses. The higher education community in whose behalf I am appearing today also recognizes the necessity of working toward a solution to the budget deficit that imperils the economic recovery in which we, like all Americans, have great hope. We are concerned, however, about the imponderable result of this proposed change in programs with long history and notable results.

No new circumstances exist to justify the repeal of the congressional decision to treat all such programs as scholarships.

One of the major arguments put forward for codifying the tax treatment of a variety of programs is the increasingly common practice of providing tax-free fringe benefits rather than cash compensation to employees. Programs of tuition remission do not fit this mold. The number of colleges and universities participating in both tuition exchange and off-campus grant programs has not grown in the past decade. Indeed, some campuses in examining their budgets have been forced to limit such scholarships—by making portable tuition remission grants available only to faculty employed before 1978, for example. Other campuses have held constant the size of the available off-campus grant, despite substantial inflation. This treatment is in keeping with the normal decisions an institution must make on the use and distribution of its scholarship funds.

Further, tuition remission benefits are not offered, and never have been offered, in a compensatory manner. No cash or other benefit is provided to other employees, their spouses, or children, who do not participate in such programs. It is not part of an employee's bottom line, nor should it be. The beneficiary is not usually the employee but an individual—spouse or child—who has no obligation to the institution. In fact, some campuses offer such scholarships to the children of deceased and retired faculty.

If Congress classified these programs as fringe benefits, would colleges and universities be required to extend comparable benefits to all employees? If so, the costs for many institutions would probably be so great that the program would simply be foregone.

Portable tuition remission programs fall within the common understanding of the meaning of "scholarship."

### A. THE HISTORICAL CASE

Section 61 of the Code provides, generally, that all income, from whatever source derived, is included in gross income for tax purposes. The Code excludes, however, certain specified items from gross income. Since the enactment of the income tax, the receipt of gifts has been excluded from gross income, and prior to the enactment of the 1954 Code, most scholarships were included in the concept of gifts not subject to tax. Consequently, prior to the enactment of the 1954 Code, benefits received under any of the three types of tuition remission plans were treated as scholarships, which, in turn, were treated for income tax purposes as gifts, and therefore not taxed to the parent of the child who received the benefits.

Congress substantially revised the tax laws in 1954, and as part of that revision took all scholarships out of the "gift" category for purposes of determining whether the receipt of a scholarship was taxable income and placed them under a new provision, Section 117 of the Code, which provides a detailed treatment of the determination of the exclusion of scholarships or fellowships from gross income. The stated congressional purpose for separating scholarships from the more general category of gifts was to attempt to eliminate the confusion which then existed in distinguishing between scholarships which were excludable from income as gifts and those grants which were not appropriately excluded because they actually constituted compensation for services. S. Rep. No 1622, 83d Cong., 2d Sess. 17 (1954).

Section 117, subject to certain specified limitations, generally excludes from income any amount received by an individual as a scholarship. Importantly, however, the section does not contain a specific definition of the word "scholarship." The committee reports which accompanied the enactment of the 1954 Code gave only a single illustration of a scholarship which was excluded from income under Section 117 and that illustration was a portable tuition remission plan:

"If an educational institution . . . maintains or participates in a plan whereby the tuition of a child of a faculty member of any such institution is remitted at any other participating educational institution . . . attended by such child, the amount of tuition so remitted shall be considered to be an amount received as a scholarship under this section." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A 37 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 188 (1954).

Thus, as stated in these reports, Congress intended that the benefits received under tuition remission plans continue to be excluded from income after the enactment of the 1954 Code as a scholarship under § 117.

In 1956, Treasury issued regulations under § 117, which defined the term "scholarship" for purposes of that section in order to supplement the definitional reticence of the Code section itself. Importantly, the regulations follow almost verbatim the language contained in the committee reports that refer to tuition remission plans;

"If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship." Treas. Reg. § 1.117-3(a) (1956).

Thus, as stated in the regulations, benefits received under tuition remission plans are scholarships for purposes of § 117, and therefore are excluded from income.

Since the issuance of the regulations in 1956, the IRS has on several occasions reiterated the position that the benefits received under any of the three types of tuition remission plans are scholarships under § 117. On November 30, 1971, the Chief of the Individual Income Tax Branch of the National Office of the IRS issued to a large university a letter ruling which, after referring to Treas. Reg. § 1.117-3(a), stated:

"It is clear, however, that Congress intended to treat as a scholarship the amount of tuition of a dependent child of a faculty member that is remitted pursuant to a plan for such remittance maintained by an educational institution with another educational institution. The same result should obtain where an educational institution maintains a plan to waive the tuition of the dependent children of its faculty members when such children attend the educational institution that employs the parents."

The letter ruling concluded that the university's plan for tuition remission at the faculty member's institution "is not includable in the gross income of the employees, their dependents or spouses, under Section 61 of the Code, but is excludable as a scholarship or fellowship under § 117 of the Code."

The Service confirmed this conclusion again in 1972. In 1971 and in 1972, certain IRS agents, in approximately twenty audits involving all three types of tuition remission, questioned whether tuition remission should be treated as taxable income to faculty members. After a series of conferences sponsored by the National Office of the IRS and attended by organizations representing colleges and universities, the Chief of the Individual Income Tax Branch informed the counsel for the American Council on Education, by a letter dated September 8, 1972, that a reply had been sent to the various district directors who had submitted requests for technical advice, and that "the manner of our suggested disposition of these cases will meet with your approval." The letter added that "a representative of the involved district directors will be contacting the subject universities and colleges to discuss the matter." All of the cases were subsequently resolved without any sugestion that the benefits under any of the three types of tuition plans should not be treated as scholarships under § 117.

In summary, unlike many of the fringe benefits that have been called into question within the last few years, the benefits received under all three forms of tuition remission are unquestionably excluded from income and have been so excluded since the beginning of the income tax. This conclusion rests soundly upon the committee reports accompanying the 1954 Code, the contemporaneous enactment of the regulations defining a scholarship under § 117, and the administrative interpretations followed by the IRS for more than twenty-two years. Thus, at the present time, all benefits received under any of the three types of tuition remission plans are scholarships under § 117 and, therefore, are not subject to taxation.

### B. THE THEORETICAL CASE

As noted earlier, § 117 itself does not define the term "scholarship" for purposes of that section. The Treasury Regulations issued for § 117, however, provide a definition for that term, and the Supreme Court in *Bingler* v. *Johnson* has approved the definition supplied by the Treasury. 394 U.S. 741 (1969).

The pertinent part of the definition of a "scholarship" as provided in the regulations is as follows:

"A scholarship generally means an amount paid or allowed to, or for the benefit of a student, whether an undergraduate or graduate, to aid such individual in pursuing his studies." Treas. Reg. § 1.117-3(a).

Treasury Regulation § 1.117-4(c) outlines, however, three factual patterns under which a grant will not be treated as a scholarship and, therefore, will be included in gross income for tax purposes:

(1) The recipient is really an employee of the granting institution and the grant represents compensation for services.

(2) The recipient of the grant is performing substantial services, research, or studies which are under the direction or supervision of the granting institution.

(3) The purpose of the grant is to enable the recipient to pursue studies or research primarily for the benefit of the grantor. This test requires a determination of the primary purpose of the grant—was it to further the education of the recipient, or to provide research or studies that primarily serve the interest of the grantor.

The purpose of the consideration of the regulations is to determine whether, within the guidelines of the regulations, the benefits received under tuition remission plans more nearly resemble for tax purposes the typical bilateral scholarship grants, which are clearly excluded from income, or compensation income. The three tests provided by the regulations for determining whether a scholarship exists within the meaning of § 117 appear to have been drafted with only the bilateral transaction in mind. Indeed, this conclusion makes sense in light of the fact that benefits under tuition remission plans are expressly and unconditionally included as scholarships in the regulations, thereby removing any need to examine them, like other scholarships, under the tests concerning performance of services by the recipient or primary purpose of the grant.

Nevertheless, these tests are helpful to the question at hand since they are based on long-accepted concepts (that have developed since the beginning of the income tax through court decisions and IRS administration) that a scholarship, to be nontaxable, should be a relatively disinterested grant to a student to pursue his studies at the granting institution (e.g., not a grant in payment for services or for the primary benefit of the granting institution). Again, to repeat for emphasis, the concept is not one of total disinterest on the part of the granting institution but rather one of relative disinterest. The Supreme Court, in *Bingler* v. *Johnson,* 394 U.S. 741 (1969), its only decision to consider § 117, described scholarships as "relatively disinterested, 'no strings' educational grants, with no requirements of any substantial quid pro quo from the recipients." Id. at 751. Although this quote was made in reference to a bilateral transaction, it is nevertheless helpful in that it succinctly describes the type of grant that has always been treated as a scholarship.

Using the Court's language in *Bingler,* are the benefits under a tuition remission plan a "relatively disinterested" grant with no requirement for a "substantial quid pro quo"? First, from the standpoint of the parent, the grant to his child does not require any substantial quid pro quo on the part of the parent. In order for the child to be eligible for the grant, the parent must be employed by the granting institution, but the performance of services by the parent should not be viewed as a quid extracted for the quo of the tuition remission, since the services are totally compensated for by the regular salary paid by the institution to the parent. This point is aptly illustrated by the fact that faculty members without dependents qualifying for the tuition remission do not receive any other type of benefit to offset the fact that some of their colleagues have such dependents receiving a tuition remission benefit. Furthermore, the receipt by a dependent of tuition remission benefits has no connection with the amount or value of the services rendered by the parent to the granting institution before, during, or after the receipt of the benefits. Rather, the existence and amount of the benefit is entirely dependent upon the educational requirements of the child receiving the benefits and the ability of the child to be admitted to and matriculate at an institution of higher education.

Second, again looking at the Court's language in *Bingler,* the benefits under the tuition remission plans are a "relatively disinterested" grant. Like all other scholarships that are excluded from income under § 117, the grants under tuition remission plans provide benefits to the granting institution, but these benefits are not different from the benefits derived from any type of scholarship. For example, colleges and universities grant athletic scholarships to produce better teams to participate in intercollegiate sports. Success in sports is often important to enhance the national reputation of the granting institution. This reputation, in turn, enables the institution to attract students on a national basis and to increase its fundraising ability among alumni. Other scholarships may be restricted by geographical location in order to assure, for example, geographical diversity among the students, or that certain types of students will attend the institution. Merit scholarships are issued to assure the membership in every entering class of a certain number of students with high intellectual ability who are expected to excell in classroom performance and exercise leadership ability on campus. In turn, it is expected that these students will pursue successful careers after their graduation and by this success enhance the reputation of the institution.

Grants made under tuition remission plans serve an institutional purpose similar to those described in connection with other types of scholarships. These tuition remission grants provide institutional goodwill between the college or university and its faculty and are particularly important to efforts to retain distinguished senior faculty members. The reputation of a college or university depends first and foremost (and more heavily than on the reputation of its students for athletic prowess or intellectual achievement) upon the excellence of its senior faculty, many of whom have children of college age. Thus, all scholarships are designed to enhance the granting institution in ways that colleges and universities have traditionally believed to be important. These indirect benefits of the payment of scholarship grants are actively sought by all colleges and universities, but have never been considered sufficient reasons in themselves to impose an income tax as a result of making such a grant.

Thus, under the *Bingler* guidelines, the grants made under tuition remission plans are really no different from any other types of scholarship grants and, therefore, were correctly included by Congress in 1954 as a "scholarship" within the meaning of § 117.

Should Congress decide to alter the tax status of portable tuition remission programs, a more equitable transition rule should be provided than that contained in H.R. 3525.

While the higher education community believes there are good and compelling policy arguments for the retention of the status quo regarding portable tuition remission programs, we recognize the right of Congress to alter its view of these programs. H.R. 3525 would impose tax liability on the college employee for all portable tuition remission scholarships received after June 30, 1984. In a very real and practical sense, the net effect of H.R. 3525 is to impose retroactive liability.

Given the long history of such programs, and their congressional and IRS sanction as tax-free scholarships, it is likely that many a young family in determining a career plan were favorably influenced by the presence of such programs to teach at our nation's colleges and universities. To tell such families, after the die has been cast, that their career decision has cost them the opportunity to provide the most appropriate education for their children is to impose retroactive liability for reasonable actions that were taken in good faith. The problem is most severe for those families with children who are approaching college age or currently enrolled in a college. Such families are not likely to have provided the savings or other liquid funds to cover such additional expenses.

In 1982-83 the average cost of tuition and fees at an independent college is $4,021. The average faculty salary for all ranks is $25,697. The average salary for the highest academic rank—a full professor—is $33,391. For these parents to afford to send their children to an institution similar to the one at which they teach would require many additional years of saving. Further, students midway through an academic program may be required to change colleges or even delay their education due to the unanticipated increase in the financial burden, should H.R. 3525 stand as written.

Colleges and universities that have faced the need to cut back on their scholarship funds have adopted, in the case of portable tuition remission programs, two general approaches: freezing the dollar value of the grant offered, or limiting the benefit to those on campus at the time the decision was reached.

We urge that if Congress follows H.R. 3525 in making portable tuition remission programs taxable to the college employee, such a policy should be adopted prospectively. Thus, any college employees hired after the date of enactment of this legislation would be subject to its provisions.

In conclusion, the higher education community would urge members of this committee to retain the scholarship status of all three types of tuition remission programs. These programs are a small but valuable source of student financial aid, whose benefit to the nation in furthering educational opportunity would be imperiled if their tax-free status were rescinded. Nor would the government gain any significant revenue.

We stand ready to provide any assistance to you, Mr. Chairman, members of the committee, or your staff, that you may require. And we appreciate the opportunity afforded us to bring our views directly to your attention.

Mr. FLIPPO. Dr. Collins.

## STATEMENT OF WILLIAM COLLINS, PH. D., PRESIDENT, EXECUTIVE COMMITTEE, CORNELL UNIVERSITY CHAPTER, AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS

Mr. COLLINS. Mr. Chairman, I am William Collins, professor of psychology at Cornell University, and president of the executive committee of the American Association of University Professors, Cornell University chapter. I am speaking for that group today.

We are seriously concerned that H.R. 3525 would eliminate the tax-free status of a major portion of the Cornell children's tuition scholarship program.

There are a number of reasons for this concern, but included is our feeling that university faculty in particular, and staff as well, ought to be able to send their children to a first-rate institution.

Without programs such as this tuition scholarship program, it would become very difficult and an increasing burden for many people to do so.

I want to point out that the cost of education has increased substantially in recent years and it is not uncommon for costs to exceed $10,000 a year.

Faculty members and university and college staff members fall within a broad range of people known as the middle class. We have seen much pressure put on this particular group of people especially with regard to college. We have seen a drop in the last year particularly at Cornell in the number of middle-class students, students from middle-class families, who attend the institution.

As faculty, we are very concerned with having the broadest possible diversity in the student body. We would not like to see our institutions become places where the very rich may attend because cost is not a problem for them, and the very poor may attend because of public assistance for them.

We believe that university tuition scholarship programs are indeed scholarships, representing private support for education, and they should be encouraged.

In 1982–83, a total of 1,372 students who were children of Cornell employees were awarded scholarships through the Cornell children's tuition scholarship program; 495 students attended Cornell, while 877 students received scholarships to attend other institutions.

We know that H.R. 3525 is concerned with equity. Yet we are concerned that it may contribute an inequity particularly with respect to the matter of choice. We feel that as currently worded, H.R. 3525 is restricting the choice of institution where a student may attend. We believe that, in fact we know, that going away to college is quite advantageous. We believe it is an education in itself.

Yet, for faculty children who do not attend Cornell—and again our students attend other institutions by a ratio of 2 to 1—the parents would be taxed if their children received the scholarship. In contrast, a scholarship to attend Cornell would go untaxed.

I would say that many students go away to college not out of choice, rather by necessity. Particularly at selective institutions students are not simply admitted because their parent happens to be a faculty member. They will receive a scholarship to attend Cornell only if they have been admitted. Those people receive the advantages, as currently worded in H.R. 3525, while for students who must or choose to attend other institutions, their parents would be taxed for the scholarship amount.

We believe that is unfair.

Universities generally cannot compete with industry or with business in terms of salaries, especially in view of training and skills of faculty members. So we need a mechanism to attract and to retain highly trained individuals on the faculties. We believe that programs such as the Cornell children's scholarship program contribute to student diversity in postsecondary education, encourage highly trained scholars to take and retain college and university teaching positions, and allow the choice of which institution to attend.

We recommend that the Cornell children's tuition scholarship program for students who attend other institutions be treated as a scholarship as it is under H.R. 3525 for those who attend Cornell.

Mr. FLIPPO. Thank you, Mr. Collins.

[The prepared statement follows:]

## STATEMENT OF WILLIAM COLLINS, PH. D., PRESIDENT, EXECUTIVE COMMITTEE, AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS, CORNELL UNIVERSITY CHAPTER, ITHACA, N.Y.

### SUMMARY

The Cornell University Chapter of the American Association of University Professors is deeply concerned that H.R. 3525 would eliminate the current tax-free status of a major portion of the Cornell Children's Tuition Scholarship Program. The chapter appreciates the fact that the CCT Scholarships provided to students who attend Cornell would not be taxable. It recommends that the CCT Scholarship provided to students who attend other institutions be treated as scholarships similar to those for students attending Cornell.

In 1982–83, a total of 1,372 students who were children of Cornell employees were awarded scholarships through CCTS. CCTS scholarships were awarded to 495 students who attended Cornell, while 877 students received scholarships to attend other institutions.

I have provided a summary of the Cornell Children's Tuition Scholarship Program.

We believe that CCTS contributes to student diversity in postsecondary education, encourages highly trained scholars to take and retain college and university teaching positions, and permits students to have the benefit of a choice of institutions.

We believe that including CCT scholarships for students who attend other institutions in the gross income of Cornell faculty and staff would place a heavy burden on those who want their children to benefit from an increasingly expensive higher education.

### STATEMENT

Thank you for the opportunity to comment on H.R. 3525: Legislation Providing Permanent Rules for the Tax Treatment of Fringe Benefits. In particular with respect to this Bill's provisions regarding tuition reductions for university faculty and staff, the Cornell University Chapter of the American Association of University Professors vigorously oppose it. I must point out that the first recorded program of tuition scholarships for university employees was approved in 1901, well before the institution of the federal income tax, by the Board of Trustees of the University of Chicago. We find it ironic that such scholarship programs may now be treated as income under H.R. 3525. The irony stems from the fact that the people doing the teaching in our colleges and universities are generally of modest means, and many would find it difficult to send their children to a first-rate college because of the costs involved. The average salary of a faculty member at Cornell University, for example, is about $34,800 according to recent statistics compiled by the American Association of Universities Professors (AAUP) for the 1982–83 academic year. Yet, the cost of a year's education at Cornell University is about $13,000 (for students in Cornell's statutory colleges the cost is about $8,000 for residents, and about $10,350 for non-residents). In the words of Alain Seznec, Dean of Cornell's College of Arts and Sciences: "The average Cornell professor simply cannot afford to send his or her child to another Ivy League school . . . ." Our country has a long history of voluntary assistance to higher education and we fear that H.R. 3525 will contribute to a stifling of that assistance at the very time a need for "Excellence in Education" is being empahsized. Moreover, as our country competes in the increasing techological international marketplace, we will need highly educated workers and highly trained scholars to meet the challenge. Programs such as the Cornell Children's Tuition Scholarship (CCTS) is one way for the private sector to support higher education while also acknowledging a committment to its employees. It is one way also of preventing the unfortunate scenario of the shoemaker's children going barefoot.

At Cornell University over 600 different kinds of scholarships are available to students from college and appropriated sources. Almost as many external sources of scholarships are awarded to our students. About two-thirds of our students body is on some form of financial aid and the average scholarship award is roughly $3,500. CCTS is just one of many scholarships available. Cornell University provides almost $2.5 million to support this program each year. In 1982–83, a total of 1,372 students who were children of Cornell employees were awarded scholarships through CCTS. CCTS scholarships were awarded to 495 students who attended Cornell, while 877 students received scholarships to attend other institutions.

*The Cornell Children's Tuition Scholarship*

The Cornell Children's Tuition Scholarship plan (CCTS) provides scholarships to the children of eligible employees for study at Cornell University or other accredited degree-granting institutions.

I. Eligibility of Employee:

A. Employees hired after July 1, 1983:

1. Service Requirement: With the exception of full and associate professors, all academic and non-academic, regular full-time, and regular part-time employees are eligible for CCTS upon completion of seven (7) years of service at Cornell. Full and associate professors are eligible immediately upon appointment.

In addition, members of the ROTC staff at Cornell, employees of the Cornell Campus Store, Inc. and all Cornell United Religious Work Chaplains will be eligible for CCTS benefits following the completion of seven years service.

2. Service Accumulation: Academic employees earn one year of service during any twelve-month period in which they have at least a 50 percent appointment for at least one academic term.

Non-academic employees earn one year of service during any twelve-month period in which they have had a regular appointment for a minimum of six (6) months.

B. Employees hired before July 1, 1983:

All academic and non-academic employees who are currently eligible for CCTS under the provisions of the previous plan continue to be eligible. All regular non-exempt employees who have completed seven (7) or more years of service are eligible effective July 1, 1983.

II. Eligibility of Children: Eligible children shall include: natural-born children, adopted children, stepchildren, and foster children, provided that the foster children have been living in the home of and primarily supported by the employee for at least five years prior to application for CCTS.

III. Terms of the Award:

A Eligible childern of employees hired after July 1, 1983:

(1) Children who are admitted to an undergraduate or graduate degree program of Cornell University qualify for a scholarship which is equivalent to 50 percent of full tuition (tuition plus administrative fee).

(2) Children who attend an institution other than Cornell qualify for a scholarship which is equivalent to 30 percent of full tuition at that institution, up to a maxium equal to 30 percent of Cornell endowed full tuition. The minimum scholarship is full tuition at that institution or $1,000 per year, whichever is less.

B. Eligibility children of employees hired before July 1, 1983:

(1) Children who are admitted to an undergraduate or graduate degree program of Cornell University qualify for a scholarship which is equivalent

to the full tuition at the college less administrative fees. The minimum scholarship award is 50 percent of full tuition.

(2) Children who attend an institution other than Cornell qualify for a scholarship which is equivalent to 30 percent of full tuition at that institution up to a maximum equal to 30 percent of Cornell endowed full tuition. The minimum scholarship is full tuition at the institution or $1,000, whichever is less.

C. Awards for eligible children of part-time employees: Children of part-time employees who work more than half-time will receive an award which is prorated according to the percentage of time that they work. Employees working less than half-time are not eligible for the CCTS plan.

IV. *Duration:* CCTS will provide for up to a total of 14 semesters of study at Cornell (eight (8) semesters of undergraduate work; six (6) semesters of graduate work) toward a degree. At other institutions the total scholarship may not exceed eight (8) semesters of undergraduate work toward a degree. Part-time students will be awarded CCTS for up to a total of ten (10) semesters of undergraduate work toward a degree. Any part-time student must be enrolled for at least six (6) credits per semester; in no case will a student enrolled for fewer than six (6) credits be eligible for CCTS during the regular academic year.

A student in a degree program at another institution may take summer courses at the institution only if the graduation date is accelerated. Time spent in summer programs will be deducted from the eight semesters of eligibility available at other institutions. CCTS payments for summer course are included in the maximum for the plan year.

V. *Accreditation:* CCTS will only be awarded if the eligible child attends an institution on the list of Accredited Institutions of Higher Education published for the Federation of Regional Accrediting Commissions by the American Council on Education and is in a degree granting program. If the student attends an institution in Canada, the institution must be listed in the "Directory of Canadian Universities" published by the Association of Universities and Colleges of Canada.

An eligible child may also qualify for a CCTS award provided the proposed program requires four or more terms of academic classroom work. In such a case or in the case of an institution outside the United States, the award application will be approved or disapproved by the administrative officer in charge of the CCTS program with the advice of the Advisory Committee.

VI. *Termination of Eligible Parent:* CCTS awards will continue so long as the parent remains employed by Cornell. Awards will also be continued in the event of death, retirement or total disability provided the employee is eligible for the program at the time. If a parent ceases to be employed at Cornell for any other reason, benefits shall cease immediately and payments will be pro-rated to cover the portion of the semester during which the parent was employed. If the CCTS payment for the term has already been made for a student attending another institution, the parent will be billed for the portion of the semester remaining on the date of termination. A student attending Cornell will be billed by the Bursar for the portion of the semester remaining.

If an employee is placed on layoff status, the CCTS benefit will continue for one additional academic term.

An employee on unpaid leave of absence, i.e., University leave or departmental leave, will have CCTS benefits continued until the end of the term in which the leave begins. CCTS will then be discontinued until the employee returns to regular University service.

VIII. *Coordination of Benefits:* CCTS benefits will be coordinated with other awards which must be used to pay tuition at Cornell or tuition and fees at other institutions. All students who are residents of New York State and attending a New York institution must apply for the New York State Tuition Assistance Program (TAP) or show proof of ineligibility when they apply for CCTS awards. CCTS awards will be reduced in those instances in which the total of all awards exceeds the expenses covered under the Plan. CCTS awards will be applied after other scholarship awards have been paid.

We believe that programs such as CCTS are clearly scholarship programs and should be treated as such. CCTS covers only 50 percent of tuition; the remainder, as well as student maintenance costs (room and board, books, incidentals) must be provided from other sources. Yet, the cost of attending a high quality college continues to rise; annual expenses in excess of $10,000 are not uncommon. We fear that university faculty and staff, indeed much of the American middle class, may soon be priced out of the market for a high-quality college education. We do not want to see American colleges and universities become the province of two kinds of students only: the rich who can afford post-secondary education without concern for cost, and the poor who continue to qualify for public assistance of their educational aspirations. The loss of the broadest possible student diversity in post-secondary education would be a loss to those students who are fortunate enough to acquire college training, a loss to the institutions themselves, and a loss to the nation.

Programs such as CCTS are needed for another reason as well, which has to do with the extra-academic competition for the highly trained scholars who teach in our colleges and universities. Industry has a need for just the kind of person who teaches at the college level, particularly in the technical fields. Ph. D.'s in engineering, chemistry, or computer technology for example can command much higher salaries in business and industry. Many of the best people elect careers in industry precisely because of that fact. The problem may be approaching the crisis level in engineering as new Ph. D.'s enter industry, while those on the faculty retire or themselves consider leaving academe for better options in industry. Colleges and universities cannot offer the salary incentives that industry does, but something like CCTS can help retain faculty and attract senior talent.

We know that H.R. 3525 is concerned in part with the matter of equity, but we are concerned that it will actually contribute an inequity. I refer to the bill's provision that a scholarship to attend one's home institution would go untaxed, while a scholarship to go away to college would be treated as income. This provision reduces choice and, we believe, actually discriminates against those who want to go to college elsewhere. We believe there are real advantages to going away to school, that it is an education in itself. Furthermore, at selective institutions there is no guarantee that a faculty member's child will be admitted. That is, some students will be attending other institutions not simply by choice, but by circumstance as well. It seems unfair to us that in one case the scholarship would be taxed, while in the other case it would not.

Finally, we are concerned that the effect of H.R. 3525 may be to reduce the scholarship to an insignificant level as institutions attempt to spread out the benefit as income to all faculty and staff throughout their employment period. Such an effect would be most unfortunate as it would place an even greater burden on university faculty who want their children to benefit from an increasingly expensive higher education.

*Cornell University schedule of tuition and fees, 1983–84*

| Endowed units: | |
|---|---|
| Tuition and fees | $8,900 |
| Books and supplies | 320 |
| Room and board | 3,250 |
| Personal | 730 |
| Total | 13,200 |

| Statutory units | Resident | Nonresident |
|---|---|---|
| Tuition and fees | $3,740 | $6,050 |
| Books and supplies | 320 | 320 |
| Room and board | 3,250 | 3,250 |
| Personal | 730 | 730 |
| Total | 8,040 | 10,350 |

Mr. **Flippo.** Dr. Smart.

## STATEMENT OF G. N. RUSSELL SMART, PH. D., SENIOR PROFESSOR, DEPARTMENT OF CHEMISTRY, MUHLENBERG COLLEGE, ALLENTOWN, PA., AND EXECUTIVE DIRECTOR, TUITION EXCHANGE, INC., ON BEHALF OF THE AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS

Mr. **Smart.** Mr. Chairman, I am Russell Smart and as is true for most of us here today, I wear several hats and speak with several voices.

I am a research chemist, a college professor, a parent, and so forth. Permit me first to speak with the voice of the executive director of Tuition Exchange and, if time allows, with the voice of a faculty member whose three children have held Tuition Exchange or related scholarships.

Tuition Exchange was incorporated in 1954 under Massachusetts law as a nonprofit corporation. In the period between 1954 and 1972, Williams College assumed major responsibility for Tuition Exchange. Since 1972, Muhlenberg College has served as host to the organization.

During the most recent academic year, 594 faculty and staff children held Tuition Exchange scholarships across the Nation and, at present, there are 204 institutional members in the program. Of the 204 institutions, a substantial majority are small liberal arts colleges from the private sector.

The directors of Tuition Exchange have submitted to the staff of the House Ways and Means Committee 200 copies of a 19-page statement which opposes reclassification of Tuition Exchange scholarships as income of the parent.

In that statement we have been very presumptuous and have asked the committee to insert an additional subsection into H.R. 3525. Perhaps I can suggest the location. It would be in section 3-A, new subsection 4 on page 16, line 20:

> If an educational institution maintains or participates in the plan whereby the tuition of a child of a faculty or staff member of any such institution is reduced or remitted by any other participating institution attended by such child, then the amount of tuition so reduced or remitted shall be considered a scholarship and shall not become a part of gross taxable income.

A history of Tuition Exchange and the differences between tuition-exchange and tuition-grant scholarships are described in the full text of our report. Under H.R. 3525, as we interpret the text, tuition-remission scholarships at the home institution would not be classified as taxable but the value of tuition-exchange scholarships which allow faculty and staff children to enroll in other institutions would be classified as taxable income.

Such a policy would inflict serious injury on faculty and staff families generally, but especially at private, small liberal arts colleges. Let me cite the reasons and, also, special situations which can be remedied by the exchange process. The children of faculty and staff members of small colleges would have off-campus options. One, single-sex institutions cannot enroll opposite-sex faculty and staff children. Two, small colleges have a limited range of academic programs: Curricula such as engineering, communications, and music, may not be available on the home campus. Three, more importantly, potential limitations to maturing processes of the faculty or staff child are involved. Four, for a faculty member at a small college, the presence of one's own children or those of close colleagues in a classroom or program can generate serious professional conflicts and ethical problems.

Generally, institutional members of the Tuition Exchange program are small liberal arts colleges and are vulnerable to the hazards noted above: These hazards can be avoided by the exchange process. The child is simply replaced—I do not want to make it impersonal—by one from another institution.

When we compute or deal with tuition exchanges we do our counting in terms of semester units. We do not take tuition or the size of the scholarship into account. However, for the purposes of this presentation, we did make an assumption that these scholarships have a taxable value, and we found, over a 4-year period beginning July 1984, which is the programed date, that the tax penalty would be $8,800 for a faculty family for each child.

Based on information published in Academe, the AAUP publication, the salaries for all colleges and universities active in the Tuition Exchange program averaged $23,300. If adjusted for the distribution of the 22,000 faculty members, the average is $24,900. The range in the published data for Tuition Exchange members is $12,800 to $34,300, average annual salary. Nine member institutions have published salaries above $30,000; 38 member institutions are below $20,000.

Many comparisons can be made. Chemistry students which I will graduate next year are looking at $25,000 on the job; they will be 21 years old.

The $23,300 average for faculty members speaks for itself.

Thank you.

Mr. FLIPPO. Thank you, Dr. Smart.

[The prepared statement follows:]

# STATEMENT SUBMITTED BY DR. G. N. RUSSELL SMART, SENIOR PROFESSOR, DEPARTMENT OF CHEMISTRY, MUHLENBERG COLLEGE, ON BEHALF OF TUITION EXCHANGE, INC.

## SUMMARY

The directors of Tuition Exchange urge that H.R. 3525 be amended by inclusion of the following statement in Section 3, Exclusion from Gross Income of Certain Reductions in Tuition:

Sec.3. (a) (4). "If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty or staff member of any such institution is reduced or remitted by any other participating institution attended by such child, then the amount of tuition so reduced or remitted shall be considered a scholarship and shall not become a part of gross taxable income."

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If tuition-exchange scholarships awarded to faculty and staff children are reclassified as taxable income of the parent(s), the directors of Tuition Exchange believe:

(a) that such action would inflict serious injury on a vulnerable higher-education community;

(b) that such action would place the burden of additional taxes (estimated at $8,000 per child) most heavily on low-income faculty and staff families at small private colleges;

(c) that such action would fail to recognize the special need to provide the children of faculty and staff members at small institutions with opportunities for undergraduate education at other colleges and universities, and that tuition-exchange scholarships provide such opportunities without additional cost to the sponsor or to the host institution;

(d) that such action would force additional faculty and staff children to enroll at the home institution or to enroll at tax-supported institutions where tuitions are much lower than at independent institutions, and that many of those faculty and staff children enrolling at other than the home institution would be forced to seek need-based financial aid;

(e) that such action would yield the U.S. Treasury Department additional revenue approximating only $2,400,00 per year ($2,000 x 1,200);

(f) that such action would raise substantial administrative and legal questions:

1. If the tuition-exchange scholarship is a component of a need-based financial- aid package (as is often the case), how would the value of the tuition-exchange scholarship be computed?

2. Would the value of the tuition-exchange scholarship correspond to the published tuition of the sponsor institution or to that of the host institution?

3. Should the value of the tuition-exchange scholarship correspond to the published tuition or to the marginal cost of adding one student to an already-established academic program with unutilized capacity?

In closing this summary, the directors of Tuition Exchange acknowledge and respect the concept of non-discrimination which is strongly emphasized in H.R.3525. The issue is addressed in the full text of this statement.

## TUITION EXCHANGE STATEMENT

### 1. Introduction

These comments are addressed, with respect, to the Subcommittee on Select Revenue Measures of the Committee on Ways and Means of the U.S. House of Representatives by the directors of Tuition Exchange on behalf of member institutions and individual participants. (The names and professional affiliations of the directors are listed in Appendix I.)

These comments are offered in opposition to proposed changes in tax status of tuition-exchange scholarships. In particular, we urge the Subcommittee to continue to classify tuition exchanges available to faculty and staff children as scholarships, as noted in the record of the Second Session of the 83rd Congress:

> "----- if an educational institution ------ maintains or participates in a plan whereby the tuition of a child of a faculty member of any such institution is remitted by any other participating institution ----- attended by such child, then the amount of tuition so remitted shall be considered a scholarship ------." [House Report 1137; Senate Report 1662.]

Although tuition-exchange scholarships are our primary concern, the directors of Tuition Exchange are also distressed by other proposed changes in policy (for example, taxation of tuition-grant scholarships) which could inflict serious injury on a vulnerable higher education community.

### 2. What is Tuition Exchange?

Tuition Exchange was incorporated in 1954 under Chapter 180 of the laws of the Commonwealth of Massachusetts as an organization dedicated to "any civic, educational, charitable, benevolent, or religious purpose." There are presently 202 member colleges and universities in the program, and during the 1982-83 academic year 596 faculty and staff children from member institutions held Tuition Exchange scholarships. Although there are no barriers to membership in the program for accredited institutions, almost all members of Tuition Exchange are from the private sector of American higher education. A majority of member institutions are small, liberal arts colleges: 140 have fewer than 100 faculty members; 40 have fewer than 50 faculty members.
(The names of member institutions are listed by state in Appendix II.)

## 2. What is Tuition Exchange? (continued)

Tuition Exchange operates as a non-profit organization although it is not classified as tax-exempt. Its tangible assets approximate $20,000 and its annual income (approximately $15,000) derives largely from membership fees. The corporation maintains an office on the campus of Muhlenberg College under an arrangement whereby the college is reimbursed by Tuition Exchange for direct and indirect costs. The directors of the corporation serve without compensation, with the following exception: the Executive Director, a full-time member of the Muhlenberg College faculty, receives an honorarium of $3,000 per year for services to Tuition Exchange.

## 3. Tuition-Remission, Tuition-Exchange, and Tuition-Grant Scholarships: Definitions and Distinctions

The tradition of awarding tuition-remission scholarships to faculty children at the home institution is a very old one. It would be difficult to assign a first-occurrence date, but such scholarships were common during the depression years of the 1930's. Although tuition-remission scholarships are highly regarded by the academic community, there are some important limitations. (These limitations are discussed in Section 6 of this written presentation.)

The tuition-exchange scholarship is a logical extension of the tuition-remission scholarship. The first exchange scholarships (in the 1930's?) were bilateral in character, but "matched" scholarships of this type are difficult to arrange. In 1947, Dean Robert R. R. Brooks of Williams College developed a system of multilateral exchange scholarships. Amherst, Bennington, Bowdoin, Wesleyan, and Williams comprised the first exchange group. In 1952, Professor Frank H. Lee, of the Columbia School of Engineering, and Dean Brooks led a larger group of colleges and universities into the Faculty Children's Tuition Exchange. Following a 1953 study of the post-war economic status of college teachers (by Dr. Francis P. King, Teachers Insurance and Annuity Association), the Fund for the Advancement of Education made a generous grant which led to expansion of FCTE and to its incorporation in 1954 as Tuition Exchange.

## 3. Tuition-Remission, Tuition-Exchange, and Tuition-Grant Scholarships: Definitions and Distinctions (continued)

It should be noted that although Tuition Exchange is probably the largest organization involved with exchange scholarships, it is certainly not the only one. A number of academic consortia coordinate scholarship exchanges: Jesuit colleges, Lutheran colleges, Great Lakes Association colleges, etc. No formal count is available, but 1,200 exchange scholarships per year is probably a reasonable estimate.

The tuition-grant scholarship has a briefer history than tuition-remission and tuition-exchange scholarships. Its distinguishing feature is the issuance of checks by the sponsor-institution in favor of the host-institution, the institution enrolling the eligible faculty/staff child. Various arguments have been advanced in support of tuition-grant scholarships. It has been suggested (a) that they are easier to administer (TRUE), (b) that they offer a wider range of choices to faculty and staff children (TRUE), and (c) that they are not more costly to the sponsor-institution than a tuition-exchange scholarship (TRUE ONLY IF THERE IS UNUSED CAPACITY).

Almost all American colleges and universities offer tuition-remission scholarships. At small colleges, these are generally full-tuition scholarships; at large universities, generally only a part of the tuition is covered by tuition-remission scholarships.

Within the Tuition Exchange group, scholarships cover the full value of tuition, with the following exceptions.
(a) High-tuition colleges and universities may (but are not required to) provide less than full tuition, but not less than an amount fixed annually by the board of directors of Tuition Exchange. Based on analyses of tuition charges at all member institutions, these values were/are $5,100 for 1982-83, $5,700 for 1983-84, and $6,250 for 1984-85.
(b) Low-tuition institutions are encouraged (but not required) to supplement TE scholarship values by including a part of room/board charges.
(c) Approximately 40% of member institutions require TE applicants to apply for need-based grants and, if appropriate, they reduce the TE scholarship value. Other member institutions provide need-based aid beyond the TE scholarship.

## 3. Tuition-Remission, Tuition-Exchange, and Tuition-Grant Scholarships: Definitions and Distinctions (concluded)

Tuition-grant scholarships are much less common than tuition-remission or tuition-exchange scholarships and, generally, they provide less than full tuition: a fixed amount, or a percentage of the tuition at the home institution.

Tuition-remission, tuition-exchange, and tuition-grant scholarships for faculty and staff children are available at American colleges and universities in various permutations and combinations. Three examples are provided in Appendix III.

The number of children of faculty and contract staff families at Muhlenberg College holding special scholarships during the 1982-83 academic year was as follows:

Five (5) held tuition-remission scholarships;
Eleven (11) held tuition-exchange scholarships; and
Thirteen (13) held tuition-grant scholarships.

In addition, six (6) children of other employees (i.e. not faculty or contract staff) held tuition-remission scholarships during academic year 1982-83.

## 4. TE Scholarships: Eligibility and Competition

Institutional membership in Tuition Exchange carries few obligations, and every effort is made to keep TE relationships informal and flexible. Aside from reporting TE scholarships and paying membership and placement fees, the only obligation of a member institution is to award TE scholarships to applicants from other institutions ("imports") at a level which roughly corresponds to the number of its own faculty/staff children placed in the program ("exports").

The obligation to balance the exchange account over a reasonable period of time generates problems. At many member institutions, a number of faculty/staff children cannot enter the TE program. The reason? Although not all faculty/staff children are gifted and motivated (such might, indeed, be the exception!) there is a generalized upward mobility in this sociological group which creates an enormous demand (and competition) for TE scholarships at the strongest and best-known colleges and universities but a modest demand for TE scholarships at other institutions. Accordingly, those institutions which enroll few (or no?) TE students cannot certify the program eligibility of many (or any?) of their own faculty/staff children.

### 4. TE Scholarships: Eligibility and Competition (continued)

In short, eligibility to apply for a TE scholarship is not automatic and, at many member institutions, difficult selections must be made.

Restrictions on eligibility may be chronic or temporary. Tuition Exchange does not establish selection criteria, but a number of possible alternatives are suggested: all employees plus lottery, selected groups of employees (e.g. faculty) plus years of service. Other selection criteria suggested include financial need (of the employee family) and academic potential (of the student). Indeed, in the interest of equity, if an institution's program has been restricted, Tuition Exchange recommends that TE-scholarship eligibility be limited to two years per student or to one TE scholarship per family. However, it should be noted (again) that Tuition Exchange does not set eligibility rules. Tuition Exchange only imposes general restrictions designed to bring the program into balance.

Once eligibility has been established for a particular faculty/staff child, certification forms are issued by the designated TE liaison officer and these forms are sent directly to TE liaison officers at colleges and universities to which the student is applying. Because of the competitive character of TE scholarships, it is recommended that certification forms be mailed at least 9 months before the scheduled matriculation of the student.

When awarding TE scholarships to eligible and certified applicants, member institutions apply their own standards. The admissions process and the scholarship process are separate and a TE scholarship cannot be awarded unless/until the applicant has been admitted. If there are more qualified applicants than there are TE scholarships (the number may be limited by institutional policy or by TE controls), selections must be made. Again, Tuition Exchange does not set the rules. It is assumed that, in a competitive situation, TE scholarships are awarded based on academic potential, on financial need, on timing of the application, etc. Having been awarded a TE scholarship, the student must meet clearly articulated standards of academic performance and personal conduct to qualify for renewal.

When Tuition Exchange is asked for advice about special situations, our answer is as follows: "The TE student is on your campus in place of one of your own faculty/staff children; rules which have been developed for your own tuition-remission program should apply when dealing with a TE student."

### 4. TE Scholarships: Eligibility and Competition (concluded)

Although 256 new TE scholarships were awarded in 1982-83, many eligible students seeking such scholarships could not be placed in the program. The following cases illustrate the competitive character of the TE scholarships.

> 1. In a recent year, 18 eligible students applied for TE scholarships at Williams College. Six of the 18 students were admitted and, of the six, two were offered TE scholarships. Three of the six actually enrolled, including one of the two students offered TE scholarships.
>
> 2. An eligible faculty/staff child from Franklin Pierce College was admitted to Hartwick College but was denied a TE scholarship because Hartwick had over-enrolled TE students in prior years.
>
> 3. An eligible faculty/staff child from Bard College was admitted to Franklin and Marshall College but was denied a TE scholarship because of over-enrollment of TE students. However, this student was admitted to and was awarded a TE scholarship at Hobart and William Smith Colleges.
>
> 4. Eligible faculty/staff children from Linfield College, Marietta College, and Muhlenberg College were admitted to Wittenberg University but all three were denied TE scholarships because of the low level of usage of the TE program by Wittenberg faculty/staff families.

---

IN SUMMARY, THIS SECTION DEMONSTRATES THAT TE SCHOLARSHIPS ARE, IN FACT, SCHOLARSHIPS AND NOT FRINGE BENEFITS. AS IS TRUE FOR OTHER CLASSES OF SCHOLARHIPS, THEY ARE GENERALLY RELATED TO MERIT AND NEED.

TE SCHOLARSHIPS CANNOT APPROPRIATELY BE CLASSIFIED AS FRINGE BENEFITS BECAUSE THEY CANNOT BE GUARANTEED BY THE EMPLOYER. IF AN INSTITUTION HAS AN UNFAVORABLE EXCHANGE BALANCE, ELIGIBILITY TO APPLY FOR A TE SCHOLARSHIP CANNOT BE CERTIFIED. IF AN INSTITUTION HAS A FAVORABLE EXCHANGE BALANCE, ELIGIBILITY CAN BE CERTIFIED BUT THE APPLICANT STUDENT MAY NOT BE ABLE TO MEET MERIT AND/OR NEED TESTS AT INSTITUTIONS OF SUITABLE CHARACTER AND GEOGRAPHY.

## 5. TE Scholarships: Selection or Discrimination

H.R. 3525 appropriately stresses non-discrimination in a number of places. In Section 3 (pages 15 and 16) the following passages occur:

> "Gross income shall not include any qualified tuition reduction ..... only if such reduction is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer ....."

As noted in the previous section, students placed in the TE program ("exports") must be offset by TE students enrolled from other member institutions ("imports"). An unfavorable exchange balance at a particular institution limits the number of faculty/staff children who can be certified to apply for TE scholarships. In this situation selections must be made, based on procedures and priorities developed by that institution.

THE DIRECTORS OF TUITION EXCHANGE BELIEVE THAT SELECTIONS BASED ON CLEARLY ARTICULATED CRITERIA, APPLICABLE IN RESTRICTIVE SITUATIONS, DO NOT CONSTITUTE DISCRIMINATION AND THAT SELECTIONS WHICH TAKE INTO ACCOUNT YEARS OF SERVICE OR ACADEMIC RANK, FOR EXAMPLE, OR WHICH LIMIT ELIGIBILITY TO TWO YEARS FOR EACH FACULTY/STAFF CHILD OR TO ONE CHILD PER FAMILY DO NOT CONSTITUTE ARBITRARY ACTION.

It should be stressed that Tuition Exchange does not set selection criteria used by particular institutions. The role of Tuition Exchange is to set restrictions on the program of that institution if serious imbalances develop. Restrictions are based on 5-year moving averages for all institutions. (Formulas and examples can be provided to the Subcommittee, if needed.)

## 6. Importance of Tuition Exchange Scholarships: Educational

H.R. 3525 provides for the exclusion from gross (taxable) income of "any qualified tuition reduction." [Section 3, page 15.] It is our understanding that tuition-remission scholarships at the home institution meet the exclusion test.

The directors of Tuition Exchange support this position, but we draw attention to situations where tuition-remission scholarships may be impractical or may have shortcomings, situations which can be remedied by student exchanges.

1. Single-sex institutions cannot enroll opposite-sex faculty/staff children.

2. The children of faculty/staff members at small colleges should have "off-the-home-campus" options. Small colleges have a limited range of academic programs: curricula in engineering, communications, and music, for example, may not be available on the home campus. More important, perhaps, are potential limitations to the personal growth and the maturing process of the faculty/staff child.

3. For a faculty member at a small college, the presence of one's own children (or those of close colleagues) can generate serious professional conflicts and ethical problems.

Generally, institutional members of the Tuition Exchange program are small, liberal arts colleges which are vulnerable to the hazards cited above. These hazards can be avoided by student exchanges: the faculty or staff child is simply "replaced" by one from another member institution.

## 7. Importance of Tuition Exchange Scholarships: Economic

Reclassification of tuition-exchange scholarships as a part of gross (taxable) income would have a major and negative impact on the higher-education community generally, but the greatest burden would fall on faculty and staff families at small, private institutions. In general, members of this group are poorly paid and are the chief users of tuition-exchange programs. Faculty and staff children at major universities make extensive use of tuition-remission options but, for reasons cited above, there is little pressure on major universities to develop tuition-exchange alternatives.

Tuition Exchange accounting is based on semester units of exchange; no record is kept of dollar-value equivalents. However, for the purposes of this presentation, a projection has been developed based on hypothetical cash values.

7. Importance of Tuition Exchange Scholarships: Economic (continued)

If an eligible student elects to participate in the Tuition Exchange program rather than attend the home institution, and if exchange scholarships become a part of taxable income in July 1984, the penalty would be very heavy, as indicated by the following projection.

Table 1. Projected Tax Penalty

| Academic Year | Estimated Tuition | Estimated Tax |
|---|---|---|
| 1984-85 | $ 5,700 | $1,900 |
| 1985-86 | 6,300 | 2,100 |
| 1986-87 | 6,900 | 2,300 |
| 1987-88 | 7,600 | 2,500 |
| Totals: | $26,500 | $8,800 |

Facts: The average 1983-84 tuition at TE colleges and universities will be $5,200; the range of reported tuitions is $1,334 to $9,450. (For additional information, see Appendix V.)

Assumptions:
(1) After July 1984 TE scholarships will be taxable.
(2) Student will enter TE program as a freshman in September 1984 and continue until graduation.
(3) Tuitions will increase at rate of 10% per year.
(4) The value of a TE scholarship equals full tuition.
(5) The faculty/staff family is in the 33% tax bracket.
(6) FICA and state taxes are not included in computations.

In summary, the tax penalty would be $8,800 for the interval 1984-88, a number which should be compared with faculty salaries.

Based on information published in ACADEME (July-August 1983), 1982-83 institutional faculty-salary data for all colleges and universities active in the TE program averaged $23,300! (If adjusted for the distribution of the 22,000 faculty members, the average would be $24,900.) The range of published average salaries is $12,800 to $34,300. Nine member institutions have published average salaries above $30,000, and 38 member institutions below $20,000.

Many comparisons can be made ($24,000 starting salaries for 21-year old B.S. chemistry graduates, etc.), but the $23,300 faculty salary average speaks eloquently to the issue at hand.

AT A TIME WHEN THE AMERICAN EDUCATIONAL SYSTEM IS THE SUBJECT OF REVIEW AND CRITICISM, IT SEEMS INAPPROPRIATE TO TAKE A GIANT STEP BACKWARD.

## APPENDIX I

### Board of Directors of Tuition Exchange

| | |
|---|---|
| Dr. Francis P. King | Senior Research Officer, TIAA-CREF<br>New York, NY |
| Dr. G. N. Russell Smart | Senior Professor, Department of Chemistry<br>Muhlenberg College, Allentown, PA |
| Mr. Henry N. Flynt, Jr. | Associate Dean, Financial Aid<br>Williams College, Williamstown, MA |
| Dr. Sherrill Cleland | President, Marietta College<br>Marietta, OH |
| Dr. Thomas W. Cole, Sr. | Dean of Academic Affairs and University Ombudsman<br>University of Florida, Gainesville, FL |
| Mr. Arthur J. Fritz | Director of Financial Aid Resources<br>Syracuse University, Syracuse, NY |
| Mr. Thomas P. Lovett | Director of Financial Aid<br>Tulane University, New Orleans, LA |
| Mr. Howard D. Saperston | Director of Registration and Records<br>University of Southern California, Los Angeles, CA |

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Dr. King is Chairman of the Tuition Exchange Board.

Dr. Smart is Executive Director of Tuition Exchange.

Dean Flynt is Resident Agent of Tuition Exchange, Inc., for the Commonwealth of Massachusetts and he is a member of the Executive Committee of Tuition Exchange (together with Drs. King and Smart).

## APPENDIX II

**Tuition Exchange Membership List (August 1983) Summary: By State**

- ALABAMA
  - Birmingham-Southern C.
  - Huntingdon C.
- ARKANSAS
  - Harding C.
- CALIFORNIA
  - Chapman C.
  - Mills C.
  - Stanford U.
  - U. of Pacific
  - U. of Redlands
  - U. of Southern California
- CONNECTICUT
  - Connecticut C.
  - Quinnipiac C.
  - U. of Bridgeport
- DISTRICT OF COLUMBIA
  - American U.
  - Gallaudet C.
- FLORIDA
  - Florida Southern C.
  - Stetson U.
  - U. of Florida
- GEORGIA
  - Mercer U.
  - Oglethorpe U.
  - Shorter C.
- IDAHO
  - C. of Idaho
- ILLINOIS
  - Augustana C.
  - Aurora C.
  - Bradley U.
  - Elmhurst C.
  - Illinois C.
  - Judson C.
  - MacMurray C.
  - Monmouth C.
  - Rockford C.
  - Roosevelt U.
- INDIANA
  - Butler U.
  - Franklin C.
  - Hanover C.
  - Indiana Central U.
  - Indiana Institute of Technology
  - Valparaiso U.
  - Wabash C.
- IOWA
  - Buena Vista C.
  - Cornell C.
  - Drake U.
- IOWA (cont.)
  - Luther C.
  - Morningside C.
  - Simpson C.
  - Upper Iowa U.
  - William Penn C.
- KANSAS
  - Baker U.
  - Kansas Wesleyan U.
  - McPherson C.
  - Ottawa U.
- KENTUCKY
  - Berea C.
  - Kentucky Wesleyan C.
  - Union C.
  - U. of Louisville
- LOUISIANA
  - Tulane U.
- MARYLAND
  - Hood C.
  - Mount Saint Mary's C. (A)
  - Washington C.
  - Western Maryland C.
- MASSACHUSETTS
  - Curry C.
  - Simmons C.
  - Simon's Rock Early C.
  - Springfield C.
  - Williams C.
- MICHIGAN
  - Adrian C.
  - Hillsdale C.
  - Olivet C.
  - Siena Heights C.
- MINNESOTA
  - C. of St. Scholastica
  - Gustavus Adolphus C.
  - Hamline U.
  - Minneapolis C. of Art and Design
- MISSISSIPPI
  - Millsaps C.
- MISSOURI
  - Columbia C.
  - Culver-Stockton C.
  - Drury C.
  - Fontbonne C.
  - Kansas City Art Institute
  - Park C.
  - Southwest Baptist C.
  - Westminster C.
  - William Jewell C.
  - William Woods C.
- NEBRASKA
  - Hastings C.
  - Nebraska Wesleyan U.
- NEW HAMPSHIRE
  - Franklin Pierce C.
  - New England C.
  - New Hampshire C.
  - St. Anselm C.
- NEW JERSEY
  - Bloomfield C.
  - Caldwell C.
  - Drew U.
  - Fairleigh Dickinson U.
  - Seton Hall U.
  - Stevens Institute of Technology
  - Upsala C.
- NEW MEXICO
  - C. of Santa Fe
- NEW YORK
  - Adelphi U.
  - Alfred U.
  - Bard C.
  - Clarkson C. of Technology
  - C. of New Rochelle
  - Elmira C.
  - Hartwick C.
  - Hobart & Wm. Smith C.
  - Hofstra U.
  - Keuka C.
  - Marist C.
  - Marymount C.
  - Nazareth C.
  - Niagara U.
  - Pace U.
  - Polytechnic Institute of New York
  - Pratt Institute
  - Rochester Institute of Technology
  - Russell Sage C.
  - St. Bonaventure U.
  - St. John Fisher C.
  - St. Lawrence U.
  - Sarah Lawrence C.
  - SUNY-Buffalo
  - Syracuse U.
  - Union C.
  - Wagner C.
  - Wells C.
- NORTH CAROLINA
  - Greensboro C.
  - Guilford C.
  - Lenoir-Rhyne C.

## APPENDIX II (concluded)

**Tuition Exchange Membership List (August 1983) Summary: By State**

- NORTH CAROLINA (cont.)
  - St. Andrews Presbyterian C.
  - Salem C.
- OHIO
  - Baldwin-Wallace C.
  - Capital U.
  - Cleveland Inst. of Art
  - Defiance C.
  - Denison U.
  - Findlay C.
  - Heidelberg C.
  - Hiram C.
  - Marietta C.
  - Mount Union C.
  - Otterbein C.
  - Wittenberg U.
  - Wooster C.
- OREGON
  - Linfield C.
  - Reed C.
  - U. of Portland
  - Willamette U.
- PENNSYLVANIA
  - Albright C.
  - Bucknell U.
  - Elizabethtown C.
  - Franklin & Marshall C.
  - Geneva C.
  - Juniata C.
  - Keystone Junior C.
  - LaSalle C.
  - Lebanon Valley C.
- PENNSYLVANIA (cont.)
  - Lycoming C.
  - Moore C. of Art
  - Moravian C.
  - Muhlenberg C.
  - Philadelphia C. of Art
  - Philadelphia C. of Pharmacy & Science
  - Susquehanna U.
  - U. of Pittsburgh
  - Ursinus C.
  - Widener C.
  - Wilkes C.
  - York C. of Pennsylvania
- RHODE ISLAND
  - Providence C.
- SOUTH CAROLINA
  - Coker C.
  - Erskine C.
  - Newberry C.
  - Presbyterian C.
  - Wofford C.
- TENNESSEE
  - Lambuth C.
  - Milligan C.
  - U. of the South
- TEXAS
  - Baylor U.
  - Dallas Baptist C.
  - McMurry C.
  - Southwestern U.
  - Texas Wesleyan C.
  - Trinity U.
- TEXAS (cont.)
  - U. of Mary Hardin-Baylor
- UTAH
  - Westminster C.
- VERMONT
  - Norwich U.
  - Saint Michael's C. (A)
- VIRGINIA
  - Bridgewater C.
  - Emory and Henry C.
  - Ferrum C.
  - Hollins C.
  - Mary Baldwin C.
  - Randolph-Macon C.
  - Randolph-Macon Woman's C.
  - Shenandoah C. & Conservatory of Music
  - U. of Richmond
  - Virginia Military Inst.
  - Virginia Wesleyan C.
- WASHINGTON
  - U. of Puget Sound
  - Whitworth C.
- WISCONSIN
  - Beloit C.
  - Carthage C.
  - Northland C.
  - St. Norbert C.

(A) Institution has applied for membership in Tuition Exchange.

## APPENDIX III

### Examples of Variations in Scholarship Programs

LEHIGH UNIVERSITY (Not a member of Tuition Exchange program.)

Tuition-remission/reduction scholarships. Limited to one-half of Lehigh's tuition. Faculty and professional staff: no prior years of service; support staff: three years of prior, full-time service.

Tuition-exchange scholarships. Exchange program limited to regional consortium and area colleges (LVAIC and NCACC) and limited to two courses per semester. Available to faculty and professional staff and to support staff: no prior-service requirement.

Tuition-grant scholarships ("Faculty Children's Scholarships"). Limited to one-half of Lehigh's tuition, or tuition of host institution (if less). Available only to faculty and professional staff: no prior service requirement.

MUHLENBERG COLLEGE (Member of Tuition Exchange program.)

Tuition-remission scholarships. Full tuition. Available to all employees: faculty and contract staff, two years of prior service; other employees, five years of prior service.

Tuition-exchange scholarships. Tuition Exchange, Lutheran consortium (LCA), regional consortium (LVAIC). Available only to faculty and contract staff: three years of prior service, except that children already holding such scholarships when parent is employeed by the college may continue in the program.

Tuition-grant scholarships. Limited to 83% of Muhlenberg's tuition, or tuition of host institution (if less). Limited to faculty and contract staff employeed by Muhlenberg College before September 1, 1978.

THE PENNSYLVANIA STATE UNIVERSITY (Not a member of TE program.)

Tuition-remission/reduction scholarships. 75% of tuition. Available to children of all full-time employees: no prior service requirements.

(Tuition-exchange and tuition-grant scholarships are not available under the Penn State program.)

## APPENDIX IV

### Examples of Tuition Exchange Scholarships

### HOOD COLLEGE, MARYLAND

| Student | "Exporting" College | Student | "Importing" College |
|---|---|---|---|
| IM-1 | Western Maryland C. (MD) | EX-1 | Western Maryland C. (MD) |
| IM-2 | Elizabethtown C. (PA) | EX-2 | Franklin & Marshall C. (PA) |
| IM-3 | Berea C. (KY) | EX-3 | Bucknell U. (PA) |
| IM-4 | Marietta C. (OH) | EX-4 | American U. (DC) |
| | | EX-5 | Baldwin-Wallace C. (OH) |
| | | EX-6 | Western Maryland C. (MD) |

### LUTHER COLLEGE, IOWA

| Student | "Exporting" College | Student | "Importing" College |
|---|---|---|---|
| IM-1 | Simpson C.( IA) | EX-1 | Simpson C. (IA) |
| IM-2 | Buena Vista C. (IA) | EX-2 | St. Lawrence U. (NY) |
| IM-3 | Upper Iowa U. (IA) | EX-3 | Bucknell U. (PA) |
| IM-4 | Hamline U. (MN) | EX-4 | Trinity U. (TX) |
| IM-5 | Hanover C. (IN) | | |
| IM-6 | Gustavus Adolphus C. (MN) | | |
| IM-7 | Buena Vista C. (IA) | | |

### MARIETTA COLLEGE, OHIO

| Student | "Exporting" College | Student | "Importing" College |
|---|---|---|---|
| IM-1 | Monmouth C. (IL) | EX-1 | Franklin C. (IL) |
| IM-2 | Juniata C. (PA) | EX-2 | Hood C. (MD) |
| IM-3 | Philadelphia C. of Art (PA) | EX-3 | Baldwin-Wallace C. (OH) |
| IM-4 | Baldwin-Wallace C. (OH) | EX-4 | American U. (DC) |
| IM-5 | American U. (DC) | EX-5 | Willamette U. (OR) |
| IM-6 | Marymount C. (NY) | | |
| IM-7 | New England C. (NH) | | |

### WILLAMETTE UNIVERSITY, OREGON

| Student | "Exporting" College | Student | "Importing" College |
|---|---|---|---|
| IM- 1 | U. Southern California (CA) | EX-1 | Alfred U. (NY) |
| IM- 2 | Westminster C. (UT) | EX-2 | Pace U. (NY) |
| IM- 3 | Whitworth C. (WA) | EX-3 | Franklin Pierce C. (NH) |
| IM- 4 | U. of Portland (OR) | EX-4 | U. of Southern California (CA) |
| IM- 5 | U.of the Pacific (CA) | EX-5 | Mills C. (CA) |
| IM- 6 | U.of the Pacific (CA) | EX-6 | Drury C. (MO) |
| IM- 7 | Hamline U. (MN) | EX-7 | U. of the Pacific (CA) |
| IM- 8 | Drake U. (IA) | EX-8 | U. of the Pacific (CA) |
| IM- 9 | U. of the Pacific (CA) | EX-9 | U. of Southern California (CA) |
| IM-10 | U. of the Pacific (CA) | | |
| IM-11 | Marietta C. (OH) | | |

"IM" = "imported" student. "EX" = "exported" student.

During the 1982-83 academic year, 594 faculty and staff children held TE scholarships.

## APPENDIX V

### Analysis of Tuition Charges at TE Colleges and Universities

The purpose of this analysis is to establish a "minimum value" for 1984-85 TE scholarships at high-tuition colleges and universities. High-tuition member institutions are permitted (but not required) to award less than full tuition but not less than the "minimum value" established by the TE board of directors.

The "minimum value" is adjusted each year by the TE board based on tuitions reported by member institutions. To provide ample time for notification, tuitions for a given academic year are used to determine the "minimum value" for the following academic year. Accordingly, in the current analysis, 1983-84 tuitions were used to establish the 1984-85 "minimum value" of $6,250.

In a few cases, member institutions did not report tuitions early enough to be included in the analysis. In such cases, estimated values were used. The estimates were derived by adding 10% to 1982-83 tuitions. Based on experience, the "minimum value" corresponds to the tuition of member institutions in the 19th-20th rank percentile.

The following table provides data used to establish the "minimum value."

| Year | Minimum $ | Average $ | Median $ | Maximum $ | 19.5 Rank %ile | "Minimum" Value ($) | TE Scholarship for Year |
|---|---|---|---|---|---|---|---|
| 1977-78 | 618 | 2,796 | 2,800 | 4,750 | 3,348 | 3,350 | 1978-79 |
| 1978-79 | 645 | 3,037 | 3,025 | 5,130 | 3,650 | 3,650 | 1979-80 |
| 1979-80 | 684 | 3,346 | 3,360 | 5,595 | 4,037 | 4,050 | 1980-81 |
| 1980-81 | 729 | 3,699 | 3,690 | 6,430 | 4,500 | 4,500 | 1981-82 |
| 1981-82 | 786 | 4,220 | 4,160 | 7,450 | 5,100 | 5,100 | 1982-83 |
| 1982-83 | 700 | 4,707 | 4,590 | 8,700 | 5,700 | 5,700 | 1983-84 |
| 1983-84 | 1,334 | 5,175 | 5,040 | 9,450 | 6,250 | 6,250 | 1984-85 |

When Tuition Exchange balance sheets are prepared annually for all member institutions, tuition values are not taken into account. Balance sheets are based only on semester units of exchange.

Mr. **Flippo**. Mr. Duncan.

Mr. **Duncan**. Thank you, Mr. Chairman. I want to thank the panel, also.

Dr. Smart, I noticed in the Tuition Exchange membership list that you have very few State universities listed; most of them are private. I wonder why. Can you tell us why that is true?

Mr. **Smart**. Yes. I think that the basic reason is that in a large institution—my wife teaches at Penn State University—there are many, many programs available. Faculty children, if they want to go into engineering, communications, whatever, have those programs available.

Also, in a large university setting there is an anonymity which protects the teaching parent, for example, from the child faculty, and vice versa.

Accordingly, there are fewer restrictions and constraints on the growth of the faculty child, and there are fewer professional hazards for the parent.

Of course, many of the large universities and public institutions are dealing with tuitions of possibly $2,000 a year, which is approximately what Penn State charges, but a typical private college such as Cornell is $7,000 or $8,000.

Mr. **Duncan**. I notice Dr. Carr is from what we call a little university, because we have the University of Tennessee in Knoxville. But it is not a member of your group.

Mr. **Smart**. That is correct. There is an added reason for that. In the 1950's and 1960's, as the tuition exchange program was being developed, there was enormous pressure for students who wanted to enter Cornell, for example. Massachusetts Institute of Technology was a charter member, as was Amherst, et cetera. The imbalance was so great that some of the prestigious institutions withdrew and moved to a cash-grant system. It was easier to operate.

Mr. **Duncan**. Thank you, Mr. Chairman.

Mr. **Flippo**. I would like to ask a question. If any other employer offered to pay for the college education of an employee's child, would it be considered a scholarship? Is this not clearly a form of compensation for the employee's services and should be subject to the rules governing fringe benefits? Perhaps it is justifiably excluded by some measures, but I wonder what your response would be.

Mr. **Carr**. Mr. Chairman, I can say a thing or two on that. We do not think that this is a fringe benefit in essence. These scholarships are like other scholarships in basic fundamental important ways. The objective of these scholarships as in the case of other scholarships is the education of students, the beneficiaries of the scholarships are students, not the parent or not the grantor, not the institution in the end, but the students themselves.

The scholarships carry no real strings with them. The students who receive them are not required to return services to the institution, they are not restricted in the majors they can choose. So we think that the primary characteristic of these programs is as a scholarship.

Mr. **Flippo**. I thank you for your response. I realize that this is one approach to take, but it seems that if any other employer paying for the college education of an employee's child, that there are circumstances under which it would be considered a scholarship and in other cases under which it could be argued that it was for services of the employee. I appreciate your response.

Thank you very much. I appreciate the panel's testimony.

Mr. **Carr**. Thank you.

Mr. **Collins**. Thank you.

Mr. **Smart**. Thank you.

Ms. **Weber**. Thank you.

Mr. **Flippo**. Our next panel will be Mr. William E. Sanders, vice president of personnel, Sears, Roebuck & Co.; from the National Retail Merchants Association, Dexter Tight, senior vice president and general counsel, The Gap Stores, Inc.; representing American Insurance Association, Brenda Viehe-Naess, senior counsel; and Mesa Petroleum Co., represented by Larry Gettman, director of the physical fitness programs.

I thank all of you for coming. We will make your testimony in full a part of the record, and please feel free to summarize it. You may proceed as you deem appropriate. In the absence of an order of presentation, we will proceed with Mr. Sanders.

## STATEMENT OF WILLIAM E. SANDERS, VICE PRESIDENT, PERSONNEL, SEARS, ROEBUCK & CO.

Mr. **Sanders**. I am William E. Sanders, vice president for personnel, Sears, Roebuck & Co. I appreciate the opportunity to present Sears views on H.R. 3525, both on its own behalf and on behalf of its 400,000 employees. I will confine my comments to the parts of the bill dealing with employee discount, which is important to employees throughout the entire retail industry.

At the outset I wish to state that we applaud the efforts of Chairman Stark and Mr. Conable for taking the time and devoting the expertise to formulating a bill which would bring some balance into the field of fringe benefits. We recognize that the committee staff has worked hard on this issue and has tried to accommodate the retail industry. However, in view of Sears corporate and business structure and its longstanding discount program, we do have concerns over certain aspects of the bill.

First, I would like to describe Sears discount policy and explain why we believe employee discounts should not be taxed.

Sears gives a discount to its employees and employees of its subsidiaries on their purchases. In addition, Sears has certain departments in its stores run by concessionaires, and discounts are also allowed to these concessions. The discount varies from 10 percent to 15 percent of the selling price depending upon the item. It is the same for all employees from the chairman of the board to a part-time sales clerk.

The total discount granted in 1982 was about $83 million. This was approximately 1.4 percent of total payroll of $5.8 billion.

I will now explain why we believe that employee discounts should not be taxable.

First of all, the discount is not compensatory in nature, since the benefit bears no relationship to the services performed. Sears lower paid employees probably get a relatively greater benefit than do the higher paid, since they would spend a greater percentage of their income on Sears merchandise.

In addition, employee discounts are beneficial to the employer. It is desirable from a merchandising standpoint that Sears employees own and use Sears merchandise. Further, the discount undoubtedly generates additional business and this tends to offset the cost of the lowered selling prices. Even after the discount the selling price of the merchandise would still generally exceed its cost.

Treating an employee discount as income would create administrative problems since we have over 20 million discount transactions each year. Every time an employee purchased an item, the salesclerk would have to record the discount and send it to the payroll center where the employee's records are kept, so that tax withholding could be made.

Further, retail discounts are well within the range of promotional discounts given to all customers. For example, if an employee buys an item at the regular price less 10 percent, and the same item is placed on sale to customers at 25 percent off at a later date, it is difficult to say what benefit the employee really got. Also, by carefully shopping at a number of other stores, the employee might do just as well on his own.

Taxing employee discounts would generate little revenue. The difficulty of keeping track of employee purchases would probably lead retailers to discontinue the discount practice. Obviously, it would be difficult to explain to employees at this late date why they suddenly should be taxed on their purchases.

H.R. 3525 permits a discount of up to 20 percent of the selling price on both merchandise and services, but not in excess of the employer's "profit percentage." Our discount on merchandise, and we believe on services also, meets this basic requirement.

There are, however, certain definitional problems and restrictions in the bill that are of serious concern. A major problem is the rule that employees can get a discount only on merchandise sold in the business in which they work. If a retailer has two or more businesses, the employees of one business cannot get a discount from the others.

We believe that this rule is unduly restrictive and that there will be endless interpretative problems as to what is a single business. For example, Sears operations include large retail stores, catalog sales operations, paint and hardware stores, and stores which sell only business machines. All of these employees receive a discount on all Sears merchandise. Yet a narrow interpretation of what constitutes a single business would severely restrict this benefit. We believe that the single business requirement should be dropped.

Another problem is that the discount cannot be given to employees of related corporations, even if they are in the same business. Thus, to the extent we have employees who are involved in our retail business but are employed by a subsidiary, they would not qualify for the discount at our stores.

Further, employees of such Sears subsidiaries as Allstate Insurance, Dean Witter Financial Services, and Coldwell Banker Real Estate would not qualify, both because they may be in a different business and because they are employed by separate corporations. Allstate employees have received the discount since 1934. We believe employees of all Sears subsidiaries should be allowed a Sears discount.

This is particularly valid since many of our subsidiaries conduct at least part of their operations in Sears stores.

The discount should not be limited to employees working in a particular business or corporation. Where there is common ownership, the employees of different businesses or corporations should be entitled to discounts on all items sold by the group. The discount is not compensatory and it also benefits the employer. It is given to employees of all Sears companies to build employee loyalty to Sears as a whole rather than only to a narrow segment of the business. Discriminating as the bill does against certain classes of affiliated employees with respect to the discount tends to negate this goal.

Thank you.

Mr. **Jenkins**. Thank you, Mr. Sanders.

[The prepared statement follows:]

## STATEMENT OF SEARS, ROEBUCK & CO. PRESENTED BY WILLIAM E. SANDERS, VICE PRESIDENT, PERSONNEL

### OUTLINE

I. Sears allows a discount on purchase made by its employees and the employees of its subsidiaries in the amount of 10 percent or 15 percent of the selling price, depending on the type of merchandise involved.

II. Employee discounts which are reasonable in amount and which are available to employees on a nondiscriminatory basis should not be taxed.

A. They are not compensatory since the amount bears no relationship to services performed.

B. Employee discounts benefit the employer.

1. Employee use of employer products helps advertise them.

2. They generate additional sales for the employer.

C. It is difficult to measure the value of the benefit.

D. Administrative problems of treating discount as taxable would be almost insurmountable and would result in discontinuance of discount programs.

III. Sears employee discount meets the nondiscrimination requirement and appears to meet the percentage limitations for nontaxability under H.R. 3525.

IV. The requirement that only employees employed in the business selling the merchandise can get a discount will cause serious problems.

A. It is difficult to determine what is one business. Would Sears retail stores and its catalog business be considered one business or two?

B. We see no reason why an employer should not be able to give discounts to all his employees, no matter what business they work in.

V. Limiting the discount to employees of the same corporation that sells the merchandise is artificial.

A. Employees of Allstate Insurance Co. and other Sears subsidiaries should be permitted to receive a discount because they are under the same ownership and under common control.

B. Most Sears subsidiaries conduct at least part of their business in Sears stores.

C. Allowing the discount to employees of related companies builds loyalty to the entire business operation of the Company rather than to only the segment in which the employee works.

VI. While H.R. 3525 permits cross-discounting between the employees of the retailer and those of leased departments, it does not go far enough. All employees in the store, whether employed by the retailer or by a leased department should be entitled to a discount throughout the store.

### STATEMENT

My name is William E. Sanders and I am Vice President, Personnel of Sears, Roebuck and Co. I appreciate the opportunity to present this statement for Sears, Roebuck and Co., both on its own behalf and on the behalf of its approximately 400,000 employees. The statement deals with the effect of H.R. 3525 on the tax treatment of so-called fringe benefits of employees. Our comments are limited to the portion of the bill dealing with employee discounts. Employee discounts have been granted by Sears for many years and are common throughout the entire retail industry. Thus, this portion of the bill is of importance not only to Sears employees, but to the employees of many other retailers as well.

Before discussing the impact of H.R. 3525 on present law, we would first like to describe briefly Sears policy with respect to employee discounts, and explain the reasons why we believe that employee discounts should not be taxed.

*Sears policy with respect to employee discounts*

Sears has a policy of giving discounts to its employees and to the employees of its subsidiaries to encourage them to buy the merchandise which it sells. The discount is quite reasonable, amounting to only 10 percent of the selling price on most items of merchandise; although, on some items, mainly clothing, on which there is a higher markup, it is 15 percent of the selling price. All Sears employees, including everybody from the Chairman of the Board to a part-time sales clerk, are entitled to this discount. Also, all employees of its subsidiaries, such as Allstate Insurance, Coldwell Banker and Dean Witter, are entitled to the discount on the merchandise they purchase. Thus, the discount is completely nondiscriminatory.

The employee is permitted a discount only on items purchased for himself or his immediate family. In addition to the employee himself, one member of his family is also given a discount card as are his student dependents who are between the ages of 16 and 23. Totally disabled employees, retirees, spouses of deceased and spouses of deceased employees are also entitled to the discount under certain circumstances. Identification is required at the time of purchase in order to receive the discount.

Also, Sears has certain concessions or "leased departments" in its stores which are operated by independent contractors. Some service concessions, such as carpet cleaning, etc. are actually operated outside the stores. All of these concessions are treated, for discount purposes, as part of the Sears operation and employees of these concessions receive the standard Sears employee discount and Sears employees also receive a discount from the concessionaires.

In addition to the Sears discount, Coldwell Banker, which is engaged in the real estate brokerage business, also gives Sears employees, and the employees of other Sears subsidiaries, a 10 percent discount on its real estate commission if they buy or sell a home through Coldwell Banker. Further, Allstate Enterprises, Inc. gives the employees of Sears and its subsidiaries a discount on auto loans in the form of an interest rate which is generally ½ percentage point lower than that charged to the general public on new car loans.

For 1982, the total discount granted by Sears to its own employees and the employees of all its subsidiaries amounted to about $83 million. This equalled about 1.4 percent of Sears total payroll of $5.8 billion. Further, it compares with total revenues of all the Sears companies of $30 billion, and total revenues of the Sears Merchandise Group of almost $21 billion. It is not possible to determine the cost to Sears of the benefit since any cost involved would be at least partially offset by the profit on any additional sales which are made as a result of the discount. We do not have exact figures available on the amount of discount given by Coldwell Banker on real estate commissions, but it would be less than $500,000 for all of last year. The total amount of employee discount on new auto loans by Allstate Enterprises last year was also under $500,000.

*Reasons for not taxing employees on retail store discounts*

There are sound reasons why employee discounts which are reasonable in amount and which are available to employees on a nondiscriminatory basis should not be treated as taxable to them.

First of all, this type of employee benefit is not compensatory in nature since the amount of benefit bears no relationship to the services performed. As a matter of fact, it is likely that Sears lower paid employees get a proportionately larger benefit than do higher paid employees since they probably spend a greater percentage of their income on the type of items Sears sells.

There are a number of good business reasons other than to benefit the employees why employers grant discounts. First of all, the employer wants his employees to use his products because it helps to advertise them. It is desirable from Sears standpoint for its employees to use appliances in their homes which are sold by Sears and not by another retailer. Also, the employee discount undoubtedly generates additional business for the Company, and the profit from this additional business tends to compensate for the lowered selling price. In this respect, it must be kept in mind that even with a 10 percent or 15 percent discount, the selling price of the merchandise would generally be above its cost to Sears.

Another reason why employees should not be taxed on their discounts is that they are well within the normal range of promotional discounts given to all customers; and thus, it is extremely difficult to measure the value of the benefit. For example, if an employee buys an item at regular price less a 10 percent discount, and then the same item is placed on sale later, and is available to customers generally at 25 percent off, it is difficult to say whether the employee really got any benefit from the discount. Further, the discount is small enough that if a person were really to shop carefully enough amoung many different retailers, he might do just as well on his own.

In addition, of course, the administrative problems which would be caused by treating this as taxable wages would be almost insurmountable. At the time the employee purchases the item there would be no way to withhold income tax. The sales clerk would not have the employee's payroll records available so no determination of the withholding would be possible. Thus, a record would have to be made of the amount of the discount, and this would have to be sent to the payroll center which has the employee's payroll records. In this regard it is important to note that during 1982 we estimate that there were over 20 million separate transactions involving employee discount. In addition to Federal taxes, it is likely that in most cases state income taxes would also have to be withheld. A further problem would be how to handle a situation where, after withholding had been made, the employee returned the item. Also, what would be done about retirees, widows and widowers who receive no compensation from the employer on which to withhold the tax?

Sometimes it has been suggested that to alleviate these administrative problems some kind of de minimus rule should be adopted. Under this type of proposal only an amount of discount which exceeds a minimum amount, such as $100 in a year, would be taxable. However, this would not solve the administrative problems at all. It would still be necessary to keep track of every purchase by each employee in order to know whether he had received more than the amount of discount on which he is not taxable.

The taxation of employee discounts will not generate significant revenue for the government. Faced with the administrative difficulty of keeping track of individual employee purchases, many retailers, with more than a few employees, would probably elect to discontinue the discount rather than be faced with the administrative burden of complying with the law. This would not be easy to explain to employees whose discounts on their purchases have been treated as nontaxable during the entire 70 year period in which the income tax laws have been in effect.

*Effect of H.R. 3525 on tax treatment of employee discounts*

H.R. 3525 permits retail employees to receive a reasonable discount from their employer, provided it is available on a nondiscriminatory basis, and in this respect the bill continues the tax treatment which has been accorded under prior law. It seems likely that many of our employees will be entitled to exclusion of their discount from income under the bill. We believe, however, that there are certain definitional problems with the bill, and also certain restrictions in the bill which will cause serious problems.

H.R. 3525 permits a discount on merchandise or services of as much as 20 percent of the selling price, but does not permit the discount to exceed the retailer's "profit percentage". Assuming that we are correct in our assumption as to the method of computing the profit percentage, Sears discount policy will easily meet these requirements.

It appears that on merchandise sales, the profit percentage is equal to the retailer's overall gross profit percentage on his total merchandise sales, presumably as determined under his inventory method. The bill is not clear as to what cost elements should be included in computing the profit percentage for services. Assuming that only direct costs would be included, then Sears discount should also qualify on services as well as merchandise.

A major problem which we see in this bill arises out of the fact that the discount can be given only to employees of the "trade or business" in which the merchandise or services are sold. If a retailer had more then one type of business, the employees of one of the businesses could not get a discount from the other even though all of the businesses were conducted by the same corporation. Thus, if the same company owned sporting goods stores and clothing stores, these could well be considered two separate businesses and cross-discounting would not be allowed.

It is our opinion that the requirement that the employee be an employee of the specific business selling the merchandise will cause endless interpretative problems.

A serious question will arise as to what one considers to be a single business. For example, Sears operates retail stores; it also sells merchandise through the Sears catalog; it operates surplus stores which sell surplus merchandise of both the retail and catalog operations; it operates some stores which sell only paint and hardware; and finally, it operates stores which sell only business machines. In addition, it has a large service operation which services the appliances and other merchandise which it sells. All these operations are conducted in one corporate entity.

At the present time, all employees in all of these types of operations (as well as employees of Allstate, Coldwell Banker, Dean Witter, etc.) are entitled to the discount. We are concerned that if this bill is adopted in its present form, and a narrow definition of what is a single business were to be adopted, the employees of the various merchandising operations of Sears itself might only be entitled to a discount on items sold in their specific part of the business. We believe that the difficulty of interpreting what is a single business is in itself a good enough reason for dropping this restriction from the bill.

Aside from the very complex definitional problems which will arise under the bill as drafted, we see no particular merit in limiting the discount only to those employees working in a particular business. Generally, the employer is trying to build loyalty to the company as a whole among his employees, and discriminating against certain classes of employees in his discount policy tends to negate this goal. We believe that there should be no limitation as to the type of business the employee is working in as long as the businesses involved are owned by the same employer.

Another problem with H.R. 3525 is that the discount can be given only to employees of the corporation which is selling the merchandise, and not to employees of subsidiaries or related corporations, even if those corporations are in the same business. Thus, employees of Sears Roebuck Acceptance Corporation, whose main function is financing inventories and receivable for the Sears Merchandise Organization, would not be eligible for a discount even if this function were considered to be part of the merchandising business. Further, if a retailer had a chain of stores all in the same business, but each was separately incorporated, the employees of each store could get a discount only at that store. In this case, if the headquarters of the operation was incorported as a separate holding company, none of the headquarters employees could get a discount at any of the stores.

As was mentioned earlier, the employees of Allstate, Coldwell Banker, Dean Witter and other subsidiaries are entitled to a discount at Sears. Allstate employees have been entitled to the discount since 1934. However, under the bill as drafted, they would no longer qualify for a Sears discount both for the reason that they may constitute a separate business and for the reason that they are a separate corporation. This problem could be taken care of by simply allowing discounts to be received by all employees of corporations under common ownership, regardless of the business in which they are engaged.

We believe, first of all, that there is no reason why employees of separate corporations under common ownership should be treated differently than employees of the same corporation. In this regard, it should be noted that for ERISA purposes all members of a "controlled group" of corporations are considered to be one employer. We believe that this same type of rule should apply to employee discounts. Thus, employees of corporations under common control should be entitled to discounts by related corporations as well as by their employer. This should be particularly true where, as in the case of Sears, several of the various subsidiaries, such as Allstate, Dean Witter, and Coldwell Banker, actually conduct a part of their operations in Sears locations, and where another subsidiary, Homart Development Co., owns and operates many of the shopping centers in which Sears stores are located.

Basically the same reasons that employees of a single corporation or business should be entitled to a discount apply where there are several businesses or corporations. That is (1) the discount is basically noncompensatory in nature, (2) it encourages the employee to use the employer's products, and (3) it generates additional sales. Further, giving a discount to employees of all the various segments of the Sears overall business helps to give the employees a feeling of loyalty to the entire corporate enterprise rather than looking narrowly only at their own segment. In addition, limiting the discount to only a portion of the employees will make it even more difficult to transfer employees from one business segment to another.

Another problem arises out of the fact that Sears, and probably most other retailers, have certain departments in their stores that are operated by independent contractors or concessionaires. As has been noted, the employees of these concessionaires receives a Sears discount and vice versa. The bill would continue this practice subject to two limitations. First, only sales of personal property over the counter and not sales of services would qualify. Second, even sales of personal property over the counter would qualify only where the concessionaire's name was not used. We believe that these limitations should not be adopted. Here too, we believe that it is desirable that all employees understand that the business as a whole must be successful if any of the specific entities are to be successful.

## STATEMENT OF DEXTER TIGHT, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, THE GAP STORES, INC., ON BEHALF OF THE NATIONAL RETAIL MERCHANTS ASSOCIATION

Mr. TIGHT. My name is Dexter Tight and I am senior vice president and general counsel of the Gap Stores, Inc. I am appearing today to testify on H.R. 3525, the Permanent Tax Treatment of Fringe Benefits Act of 1983 on behalf of the National Retail Merchants Association [NRMA]. The NRMA is a not-for-profit trade association representing over 45,000 leading department, chain and specialty stores distributing about $150 billion annually in goods and services to the American consumer.

Our members employ more than 2 million workers and approximately 75 percent are small, independent stores, selling less than $1 million per year. Retail sales as a whole represent approximately 33 percent of the GNP. I speak as well for the millions of persons currently working for our members. Since most general merchandise retailers have discount policies and the industry employees as a whole over 15 million people, a significant number of people would be adversely affected by H.R. 3525.

Not surprisingly my testimony will be very similar to the testimony from the representative of Sears. I am submitting a more detailed statement for the record but will briefly summarize key points at this time. Our opposition to this bill stems from three principal sources. First, the underlying concept of the bill is contrary on our fundamental belief that employee discounts serve vital employer interests and are not compensatory. Second, the bill would create an administrative nightmare. Finally, the bill unfairly discriminates against employees who work in retail establishments.

Turning to our first concern, employee discounts are not compensatory and should not be counted as taxable income. Employee discounts go to a group of customers who might not otherwise buy as much merchandise. Employee discounts also stimulate sales to the general public. For example, at The Gap we encourage our sales personnel to wear our merchandise by giving them a 30 percent discount with the understanding that the clothes be worn at work.

We have found employees who have had personal experience with the store's merchandise make more effective sales persons. Their morale is higher, and they often are more loyal advocates of our goods. We also firmly believe that employee discounts reduce internal theft. In addition, providing employee discounts is an effective way to advertise a store's merchandise.

For instance, recently at The Gap we had a sweat suit promotion and asked our personnel to wear the goods promoted. The results were fantastic, way beyond our expectations.

Furthermore, while the discount is an employee benefit we do not regard it as compensation because it bears no relation to job performance. The value of the discount to any individual employee depends not on the quality of his or her job performance but on the quanity of his or her purchase.

We also oppose the bill because the taxation of employee discounts would create significant administrative and compliance problems for those retailers whose discounts exceed the 20-percent limitation. Retailers would have to establish procedures whereby all store salespeople would record the purchase and discount for each employee making a purchase.

The data would then need to be cumulated and submitted to the pay payroll center. The recordkeeping changes required to identify every employee's purchase would be costly, especially for small retailers who do not have access to sophisticated computer systems.

Moreover, a change in policy to impose a tax on employee discounts would raise a difficult question of valuation. According to the technical explanation of the bill, employee discounts that do not qualify for tax-free treatment are to be taxed at their fair market value. But fair market value is fraught with problems. If The Gap is selling jeans at $22 but they are available at another store for $15, why should The Gap's employee recognize income if The Gap permits him or her to buy the time for $15.40, a 30-percent discount? It is difficult in a case such as this to identify the value that is being taxed.

Finally, we have objections to several specific provisions of the bill. These objections are detailed in our written statement. Most importantly, however, the bill makes an unfair distinction between retailing and other service industries. There is simply no sound reason why certain service industries should be able to offer discounts up to their gross margin while retailers are arbitrarily limited to a discount of 20 percent. For example, specialty stores like The Gap frequently grant employee discounts substantially in excess of 20 percent.

In conclusion then, the taxation of fringe benefits is a most complex topic. H.R. 3525 would substantially change the status quo impacting numerous employers and employees. The consistent administrative practice of the Treasury over many decades has been to view discounts as not being compensation and we believe that view presents a correct policy for today.

[The prepared statement follows:]

## STATEMENT OF DEXTER TIGHT, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, THE GAP STORES, INC., ON BEHALF OF THE NATIONAL RETAIL MERCHANTS ASSOCIATION

My name is Dexter Tight and I am Senior Vice President and General Counsel of The Gap Stores, Inc. I am appearing today to testify on H.R. 3525, the "Permanent Tax Treatment of Fringe Benefits Act of 1983" on behalf of the National Retail Merchants Association ("NRMA"). The NRMA is a not-for-profit trade association representing over 45,000 leading department, chain and specialty stores distributing about $150 billion annually in goods and services to the American consumer. Our members employ more than 2 million workers and approximately 75 percent are small, independent stores, selling less than $1 million per year. Retail sales as a whole represent approximately 33 percent of the GNP. I speak as well for the millions of persons currently working for our members. Since most general merchandise retailers have discount policies and the industry employs over 15 million people, a significant number of people would be adversely affected by H.R. 3525. My testimony today explains the NRMA's opposition to H.R. 3525's treatment for tax purposes of employee discounts.

1. *Overview.* The NRMA's opposition to H.R. 3525 stems from three principal sources. First, the bill unfairly discriminates against employees who work in retail

establishments. Second, the underlying concept of the bill is contrary to the NRMA's fundamental belief that employee discounts serve vital employer interests and are not compensatory. Finally, the bill would create administrative burdens.

2. *Discrimination Against Retail Employees.* The NRMA opposes the bill because it discriminates openly and unfairly against employees who work in retail establishments. Under the bill, employees who work in a retail establishment that provides a discount that exceeds twenty percent of the normal sales price of the merchandise would be subject to taxation on their purchases. In sharp contrast, however, the bill exempts employees in service industries from taxation on discount, or even free services, with no limitation on value as long as their employers incur no substantial additional cost (including foregone revenue) in providing the services. Thus, employees in service industries, such as airline companies, can receive free services with no tax liability under H.R. 3525. As a result of the distinction drawn by the bill, it would tax the person who saves five dollars on a twenty dollar pair of pants (a discount of 25 percent) while not taxing another who receives a 100 percent discount on an airplane flight across the country.

The sponsors of the bill have stated that the bill accommodates most existing practices of employers who offer employee discounts. The facts, however, belie this assertion. While certain large department stores allow employee discounts that do not normally exceed 20 percent, this is by no means a uniform characteristic of the industry. In point of fact, practices in the industry vary widely. For example, specialty apparel stores frequently grant employee discounts substantially in excess of 20 percent.

The apparent philosophy of the bill seems to rationalize the imposition of the 20 percent limitation on retailers on the ground that those service providers who are free of the limitation are somehow distinguishable from retailers. The distinction apparently relied upon by the bill is the fact that the employer in the preferred service industries incurs no substantial additional cost (including foregone revenue) in providing the discount service to the employee. But this distinction can not bear up under close analysis. Even if it were true that retailers forego revenue on all discount sales, there is no apparent basis for the view that this difference is a rational distinction to support the different treatment the bill accords to retailers and the preferred service providers. In addition, the underlying assumption of the bill—that retailers forego revenue on all discount sales—is of questionable validity.

The 20 percent limitation is thus an arbitrary and discriminatory treatment of the employees of retailers. There is simply no sound reason why certain service industries should be able to offer employee discounts up to their gross profit margin while retailers are arbitrarily limited to a discount of 20 percent.

3. *Employee Discounts Serve Vital Employer Interests and Are Not Compensatory.* The NRMA also opposes the bill because of its philosophy that employee discounts are compensatory. The NRMA believes that employee discounts, serve vital employer interests and are not compensatory. Accordingly, these discounts should not be included in the taxable income of our employees.

a. *Employee Discounts Stimulate Sales.* Providing discounts stimulates a company's sales to a natural group of customers who might not otherwise buy as much of the company's merchandise. Since the discounted price generally is higher than the employer's cost, by offering employees a discount, a company can increase overall sales as well as profits. The economic reasoning behind discounts is evident in the practice of some of our members of providing discounts to persons who are not, strictly speaking, employees—for example, the surviving spouses of longtime company employees, retired employees, and senior citizens. Employee discounts are a way for the retailer to reach a natural group of customers whose extensive patronage he might not otherwise obtain.

Providing discounts to employees serves another important interest of the employer—namely the stimulation of sales to the general public. By encouraging employees to purchase the employer's merchandise, employee discounts help the employer to educate his employees about the merchandise he sells. Employees who have had personal experience with the store's merchandise make more effective salespersons; their morale is higher, and they are often more loyal advocates of their employer and his goods. This rationale applies not only to salespersons but to other employees as well. For example, an assistant buyer's friends or neighbors naturally will expect him or her to have patronized the employer, and will look to the employee for his or her opinions regarding the employer's merchandise; it would hardly be to the employer's advantage if such an employee had no knowledge of the merchandise he or she was responsible for. In addition, providing employee discounts is an effective means to advertise a store's merchandise. Seeing a salesperson wearing apparel and accessories sold at the store may encourage customers to try on and purchase similar goods. Finally, providing employee discounts causes an effective stimulus to sales by a "multiplier effect." This effect results from employees being accompanied on shopping trips by others who become customers as a result of the trip.

b. *Employee Discounts Are Not Compensatory.* Employee discounts have not been taxed since the income tax was enacted in 1913. Unlike wages which compensate employees for services rendered, employee discounts bear no relationship to job performance. The value of the discount to any individual employee depends not on the quality of his or her job performance but on the quantity of his or her purchase. Accordingly, employee discounts do not constitute compensation and should not be treated as such for tax purposes.

4. *Taxation of Employee Discounts Would Create Administrative Burdens.* The NRMA also opposes the bill because the taxation of employee discounts thereunder would create significant administrative and compliance problems for those retailers whose discounts exceed the 20 percent limitation. Retailers would have to establish procedures whereby all store salespeople would record the purchase and the discount for each employee making a purchase. The data would then need to be accumulated and submitted to the payroll center. The recordkeeping changes required to identify every employee's purchase would be costly and represent a significant burden which would be particularly problematic for small retailers who do not have access to sophisticated computer systems. In addition, the bill would increase the cost of payroll taxation.

Moreover, a change in policy to impose a tax on employee discounts would also raise a difficult question of valuation. According to the technical explanation of the bill, employee discounts that do not qualify for tax-free treatment (because for example, the 20 percent limitation is violated) are to be taxed at their fair market value. But fair market value is fraught with numerous deficiencies. It is not always readily or clearly determinable. The objective dollar value of a discount simply does not accurately measure its real value. For example, comparable merchandise may be available at a promotional sale or at a nearby store at the same or even a lower net price than the employee pays with the discount. If store X's $100 item is regularly available in store Y for $75, why should an employee of X recognize income if X permits him or her to buy the item for $75 (a 25 percent discount). It is difficult in a case such as this to identify the value that is being taxed. Nevertheless, employers would be forced by the bill to do so, further complicating the administrative and compliance problems. We question whether any advantage from taxing discounts is worth the additional economic costs of compliance—especially under a bill that is not being offered as a means of increasing tax revenues.

5. *Other Problems.* The NRMA is also opposed to the provisions of the bill that prescribes the tax treatment of employee discounts in the context of (a) affiliated business and affiliated corporations and (b) leased sections of department stores in which services, as opposed to sales of property, are performed. Under these rules, two similarly situated employees could be treated differently for tax purposes. This differential treatment would occur if a single corporation's activities are broad enough to constitute more than one business or if a single business happens to be conducted through multiple corporate entities. In either such case an employee of business (or corporation) A would be taxed on his discount purchases from business (or corporation) B regardless of the fact that the two businesses (or corporations) are commonly owned and the employees of both consider themselves all to be employees of the common owner. A similar result would occur where space in a department store is leased to a service provider. The employees of the service provider would be taxed under the bill on their discount purchases from the department store even though the affected employees viewed themselves (and the public viewed them) as employees of the department store.

The NRMA opposes these rules because they discriminate between similarly situated employees and will inevitably result in dissention and lost productivity. Moreover, contrary to the assertions of the bill's sponsors, these rules dramatically reverse, rather than accomodate, the long standing existing practice. Finally, these provisions of the bill are undesirable because they are inconsistent with the underlying rationale for providing employee discounts.

6. *Conclusion.* The taxation of fringe benefits is a most complex topic. H.R. 3525 would substantially change the status quo impacting numerous employers and employees. The consistent administrative practice of the Treasury over many decades has been to view discounts as not being compensation, and we believe that view represents a correct policy for today.

Mr. JENKINS. Thank you very much, Mr. Tight.

## STATEMENT OF BRENDA R. VIEHE-NAESS, SENIOR COUNSEL, AMERICAN INSURANCE ASSOCIATION

Mrs. **Viehe-Naess**. I am Brenda Viehe-Naess, senior counsel, American Insurance Association. The association represents 164 casualty insurance companies, having a total premium volume in 1981 of $28.8 billion, or 29 percent of the $98.3 billion of the industry's direct premiums. Our members sell all types of personal and commercial insurance. Thank you for the opportunity to comment on the fringe benefit legislation today.

Our member companies recognize that this bill represents a serious effort by the subcommittee to resolve a long-standing issue. The bill has adopted a comprehensive approach to the matter, and has devised rules for many of the most troublesome problems.

There are, however, certain provisions which we believe require clarification before any final version of the bill is adopted. These are reviewed individually. The bill provides that a discount provided employees, their spouses, and children on a nondiscriminatory basis on goods or services provided to customers will be excluded from gross income if the discount is no more than 20 percent of the selling price. If applied without restriction, this rule would present no problem to insurance companies. It is common practice for companies to offer their employees a discount equivalent to the agents' commission on casualty insurance products, typically 15 to 20 percent.

However, the limitation imposed on the rule would be difficult for insurers to apply. We feel it would be difficult to explain to employees the inequity in the treatment of employee discounts in the insurance industry and other industries. The limitation provides that the excludable amount of the discount would be the lesser of 20 percent of the selling price or the employer's profit percentage, computed according to a definition in the bill. Profits for the industry, in the aggregate, have never approached the 20-percent benchmark established by the bill.

As a practical matter, substantial numbers of companies would never be able to exclude the full 20 percent. Casualty insurance is a volatile industry with wide swings in operating income—the measure most nearly equivalent to the profit measure proposed by the bill. The industry's operating income, measured as a percentage of earned premium has ranged from 0.24 percent in 1975 to 11.82 percent in 1978.

It is a cyclical industry with varying profits. Nevertheless companies have consistently offered a 15- to 20-percent discount to their employees and have paid the same commission to their agents. What we would hope is that a simple rule could be adopted for insurance companies that might be more equitable. That rule could permit exclusion of any discount on insurance contracts that represents the customary agent's commission, where the commission rate is fixed by contract with the company's agents.

A second area that presents difficulty is the restriction of the employee discount privilege to employees of a single company. State law requires that casualty and life insurance be written in separate corporations. It is, however, very common for affiliated groups of insurance companies to include both casualty and life insurance companies. Employees of the casualty company may ordinarily purchase life insurance at a discount from the affiliated life insurer, and life company employees, in turn, are permitted to purchase automobile or homeowners' coverage from the casualty affiliate. We believe that the denial of the exclusion for employees of related corporations is difficult to justify and we would prefer to see it replaced by a rule that permits discounts on purchases of products within the affiliated group.

Finally, turning to a nuts-and-bolts problem, parking, we hope that clarification of the special rule for parking will be provided. I understand today that the chairman, Mr. Stark, has said that he views the nondiscrimination provision as concerned primarily with benefits to highly compensated employees, officers, and shareholders. Nonetheless, our companies are extremely concerned about the magnitude of future audit problems. We hope that there will be no attempt by the IRS to engage in an audit procedure comparable to that now used under pension and welfare benefit plans for benefits of the prohibited group. We have seen issues like subsidized employee cafeterias taken to lengths we never would have thought possible. We hope that through work with the subcommittee staff it will be possible to clarify this rule so that questions involving proximity and seniority in determining parking will not present extensive audit problems.

Thank you.

Mr. JENKINS. Thank you very much.

[The prepared statement follows:]

## STATEMENT OF BRENDA R. VIEHE-NAESS, SENIOR COUNSEL, AMERICAN INSURANCE ASSOCIATION

I am Brenda Viehe-Naess, Senior Counsel, American Insurance Association. The Association represents 164 casualty insurance companies, having a total premium volume in 1981 of $28.8 billion, or 29% of the $98.3 billion of the industry's direct premiums. Our members sell all types of personal and commercial insurance. Thank you for the opportunity to comment on the fringe benefit legislation today.

Our member companies recognize that this bill represents a serious effort by the Subcommittee to resolve a long-standing issue. The bill has adopted a comprehensive approach to the matter, and has devised rules for many of the most troublesome problems.

There are, however, certain provisions which we believe require clarification before any final version of the bill is adopted. These are reviewed individually, in the order in which they are presented by the bill.

### 1. QUALIFIED EMPLOYEE DISCOUNT

The bill provides that a discount provided employees, their spouses, and children on a nondiscriminatory basis on goods or services provided to customers will be excluded from gross income if the discount is no more than 20% of the selling price. If applied without restriction, this rule would present no problem to insurance companies. It is common practice for companies to offer their employees a discount equivalent to the agents' commission on casualty insurance products, typically 15-20%.

However, the limitation imposed on the rule would be difficult for insurers to apply. It would create an inequity in the treatment of employee discounts in the insurance industry and other industries which would be difficult to justify to employees. The limitation provides that the excludable amount of the discount would be the lesser of 20% of the selling price or the employer's profit percentage, computed according to a definition in the bill. Profits for the industry, in the aggregate, have never approached the 20% benchmark established by the bill. As a practical matter, substantial numbers of companies would never be able to exclude the full 20%. Casualty insurance is a volatile industry with wide swings in operating income--the measure most nearly equivalent to the profit measure proposed by the bill. The industry's operating income, measured as a percentage of earned premium (the insurer's selling price) has ranged from .24% in 1975 to 11.82% in 1978 over 1951-82. (See chart attached). A simple rule that would be more equitable should be adopted. The bill should permit the exclusion of any discount on insurance that represents the customary agents' commission, where the commission rate is fixed by contract with the company's agents. This would prevent inequitable treatment which could arise because of year-to-year fluctuations in the company's profits and the traditionally low profit rates in the industry.

A second area that presents difficulty is the restriction of the employee discount privilege to employees of a single company. State law requires that casualty and life insurance be written in separate corporations. It is, however, very common for affiliated groups of insurance companies to include both casualty and life insurance companies. Employees of the casualty company may ordinarily purchase life insurance at a discount from the affiliated life insurer, and life company employees, in turn, are permitted to purchase automobile or homeowners' coverage from the casualty affiliate. We believe that the denial of the exclusion for employee discounts on products of related businesses is unfair and unjustified and should be eliminated.

2. WORKING CONDITION FRINGE

The rule excluding a working condition fringe is a fair and rational approach to many of the common incidental benefits provided employees to facilitate ordinary business operations. It would eliminate questions about routine benefits, such as subsidized employee cafeterias, that plagued this industry and many others for nearly a decade before the Supreme Court's decision in the Rowan case, 452 U.S. 247 (1981).

Clarification of the special rule for parking is needed, however. The draft rule provides that free or reduced parking will be an excludable fringe benefit only if it is available on substantially the same terms to each member of a group of employees defined under a reasonable classification that does not discriminate in favor of officers, shareholders, or highly compensated personnel. To avoid future audit problems, we believe it would be helpful if it were made clear that parking assigned on the basis of seniority with the company or according to an order established by the time of application for space will be acceptable. Parking programs using either basis should not be subjected to further detailed examinations to determine whether they provide benefits to the prohibited group.

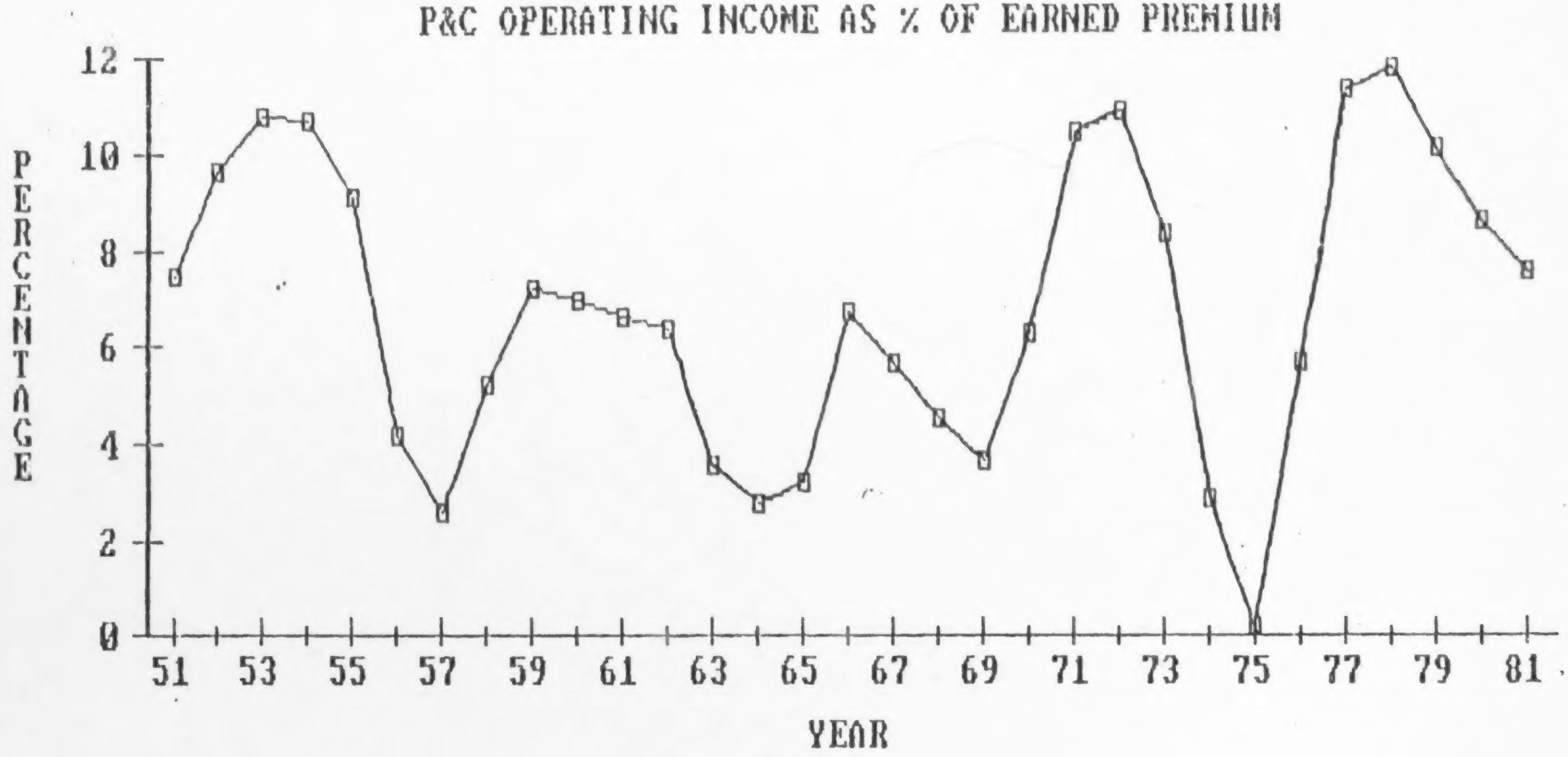
In a number of companies, parking within a short distance of an office complex is available to all employees or to those eligible on a "seniority" or "time of application" basis, but a small group of senior executives are normally provided spaces closer to the main building, because their working hours often extend beyond the routine day. It should be made clear that granting a limited group proximity in parking where the assignment can be justified by their work patterns does not violate the nondiscrimination requirement.

## 3. VALUATION OF INCLUDIBLE BENEFITS

Where fringe benefits do not qualify under one of the bills' four exclusions, a clear rule of valuation should be established. We believe includible benefits should be valued at the lower of the employer's marginal cost or fair market value.

## 4. CONSISTENCY OF INCOME TAX AND EMPLOYMENT TAX RULES

Finally, we want to stress the importance of the Act's provision that the same definition should be used for income, social security, and other employment tax purposes. We believe that lengthy, complex, and costly litigation like that involving the treatment of subsidized cafeteria meals provided employees ought to be avoided.


P&C OPERATING INCOME AS % OF EARNED PREMIUM
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YEAR

## STATEMENT OF LARRY R. GETTMAN, PH. D., DIRECTOR, PHYSICAL FITNESS PROGRAMS, MESA PETROLEUM CO., AMARILLO, TEX.

Mr. **Gettman**. Thank you. I am Larry Gettman, director of physical fitness programs for Mesa Petroleum Co. Mesa appreciates the opportunity to present its views regarding H.R. 3525. We are particularly concerned about the manner in which on-premises fitness centers would be impacted by the bill. It is Mesa's position that the tax treatment proposed under the bill is contrary to our national goals of reducing health care costs and increasing worker productivity.

We recommend that you clarify the difference between a recreational facility and a professionally run fitness center with professionally trained staff. Providing a fitness center is considered a normal course of business and its purpose is to increase productivity and reduce medical costs. As an example, Mesa since 1979 has provided an on premises fitness center at no cost on a nondiscriminatory, voluntary basis to its employees and family members.

It makes good business sense for a company to invest in fitness centers so the company has lower health care costs, lower absenteeism rates and greater productivity. The employee receives nothing of tangible value that can be used to further the employee's economic well-being. It is the company that has an economic stake in the increased productivity and reduced health care costs that are the natural result of providing a fitness center.

Therefore the company should be allowed to deduct the costs of running a fitness program as a normal course of business. Evidence that fitness is related to lower medical costs and absenteeism rates is provided in my written statement and its attached graphs. You will see in those graphs that nonparticipating employees in our fitness program averaged $434 per person in medical costs in 1982, whereas the active or participating employees averaged only $173 per person. This difference in medical costs amounts to a reduction of nearly $200,000 per year for our company in medical expenses.

Absenteeism rates were also lower for participating employees in 1982. Nonparticipating employees averaged 44 hours of sick time whereas participating employees averaged only 27 hours of sick time. With regard to productivity, Tenneco, Inc., in Houston, found a highly significant relationship between exercise participation and job performance among their employees. Employees with high ratings of job performance also had high exercise participation, indicating that productivity is related to fitness. It would be important then for a company to offer fitness programs as a prudent course of business, and statistics show that the convenience of a fitness center at the work location will significantly increase employee participation.

For example, Mesa has 64 percent of its employees currently active. Tenneco reports 81 percent participation. And Pepsico, Inc. in Purchase, N.Y., reports 52 percent are regular participants in their program. Most of the employees in these companies could not afford the purchase of similar fitness program memberships if they were offered commercially. All three of these companies provide professionally prescribed fitness programs including medical and fitness evaluations, exercise prescriptions, nutrition and weight control components.

Fitness programs are analogous to safety programs. Obviously a safety program is desirable and companies spend considerable amounts of money on safety training. It would not be reasonable to deny a deduction for such programs on the theory that they are primarily an employee benefit. Just as the employer benefits from reducing accidents on the job through his safety program, the employer benefits from the increased productivity and reduction in medical costs that result from providing its employees an on-premise fitness center.

High medical costs and low worker productivity are two very real problems faced by this Nation. H.R. 3525 would defeat incentives for companies to offer fitness centers to their employees to help curb runaway medical costs and increase productivity.

We recommend that you clarify the difference between a recreational facility and a professionally run fitness center.

Thank you.

Mr. FLIPPO. Thank you very much.

[The prepared statement follows:]

# STATEMENT OF LARRY R. GETTMAN, PH. D., DIRECTOR—PHYSICAL FITNESS PROGRAMS, MESA PETROLEUM CO., AMARILLO, TEX.

## I. Introduction

Mesa Petroleum Co. (Mesa) appreciates the opportunity to present its views regarding H.R. 3525. Mesa is strongly opposed to the manner in which on-premise fitness centers would be impacted under the bill. It is Mesa's position that the tax treatment proposed under the bill is contrary to our national goals of reducing health care costs and increasing worker productivity.

## II. Mesa's Fitness Center

Since 1979, Mesa has provided an on-premise fitness center at no cost to its 350 employees and their family members on a nondiscriminatory and voluntary basis. Presently, 62% of the participants in the fitness programs are represented by secretaries, clerical workers, and nonmanagement personnel, 35% by middle management, and 3% by top management. Employees must exercise on their own time but a flexible work schedule allows employees to include fitness as part of the working day.

## III. Companies Benefit From On-Premise Fitness Centers

It makes good business sense for companies to invest in fitness centers for their employees so that the company has lower health care costs, lower absenteeism rates and greater productivity. These outcomes are vital to a company's economic viability. The employee receives nothing of tangible value that can be used to further the employee's economic well-being. It is the company that has an economic stake in the increased productivity and reduced health care costs that are the natural result of providing employees an on-premise fitness center.

## IV. Fitness Programs Are Related To Lower Medical Costs, Lower Absenteeism Rates And Increased Productivity

In 1982, Mesa employees who did not participate in the fitness program averaged $434 per person in medical costs, paid by Mesa. However, employees who participated in the fitness program averaged only $173 per person (see attached Graph No. 1). This difference in medical costs between nonparticipating and participating employees amounts to a reduction in medical expenses of nearly $200,000 per year.

Absenteeism rates were also lower for participating employees in 1982 (see attached Graph No. 2). Mesa's nonparticipating employees averaged 44 hours of sick time, whereas, the participating employees averaged only 27 hours of sick time.

Tenneco, Inc., Houston, Texas, found a highly significant relationship between exercise participation and job performance among 3,231 employees. Employees with high ratings of job performance also had high exercise participation indicating that productivity is related to fitness.

## V. Convenient And No Cost Programs Increase Participation

It is obvious that an increased state of physical fitness will reduce a company's health care cost, lower the absenteeism rate and result in greater productivity. It would be important, then, for a company to offer fitness programs as a prudent course of business. Statistics show that the convenience of a fitness center at the work location will significantly increase employee participation. Presently, 64% of Mesa's employees utilize the on-premise facility on a regular basis. Tenneco reports an 81% participation rate in its nondiscriminatory fitness programs offered at on-premise facilities. In a similar situation, Pepsico, Inc., Purchase, NY, reports that 92% of their employees use some aspect of the fitness program and 52% are regular participants. Pepsico's fitness center is open at all times and is considered part of the working environment.

Most of the employees at these companies could not afford the purchase of similar fitness program memberships if they were offered commercially. All three of these companies provide professionally prescribed fitness programs including medical and fitness evaluations, exercise prescription, nutrition, and weight control components.

## VI. The Safety Program Analogy

Nondiscriminatory fitness programs cannot be construed to be an abuse of the taxing system under any rational theory. They are analogous to safety programs. Obviously, a safety conscious employee is desirable and companies spend considerable amounts of money on safety training. It would not be reasonable to deny a deduction for such programs on the theory that they are primarily an employee benefit. Just as the employer benefits from reducing accidents on the job through its safety program, the employer benefits from the increased productivity and reduction in medical costs that result from providing its employees an on-premise fitness center.

## VII. Congress Provides On-Premise Fitness Facilities

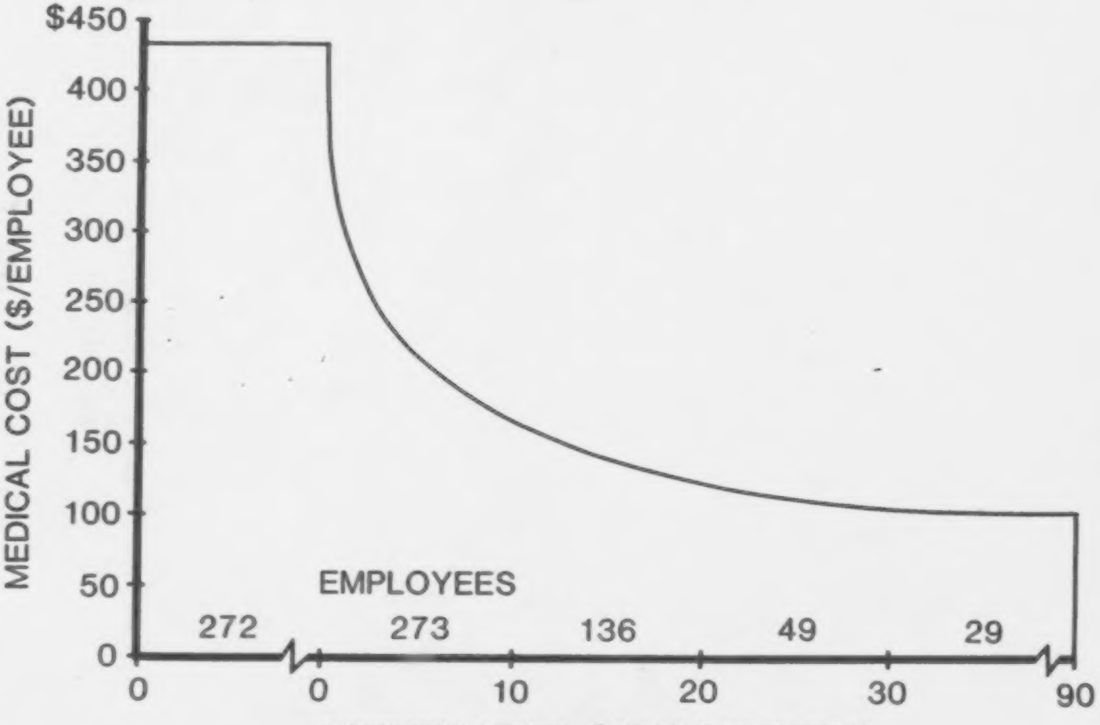
Congress itself has recognized the value of fitness programs by providing facilities for its own members. Surely these programs benefit private business and industry as well.

## VIII. The Goals of This Nation

High medical costs and low worker productivity are two very real problems faced by this nation. H.R. 3525 defeats the incentives for companies to offer fitness centers to their employees to help curb runaway medical costs and to increase productivity. Further, the bill discourages participation by employees in the on-premise fitness centers. The bill is simply counterproductive and contradicts a rational approach to solving two large scale problems in this nation.

# MESA PETROLEUM CO.

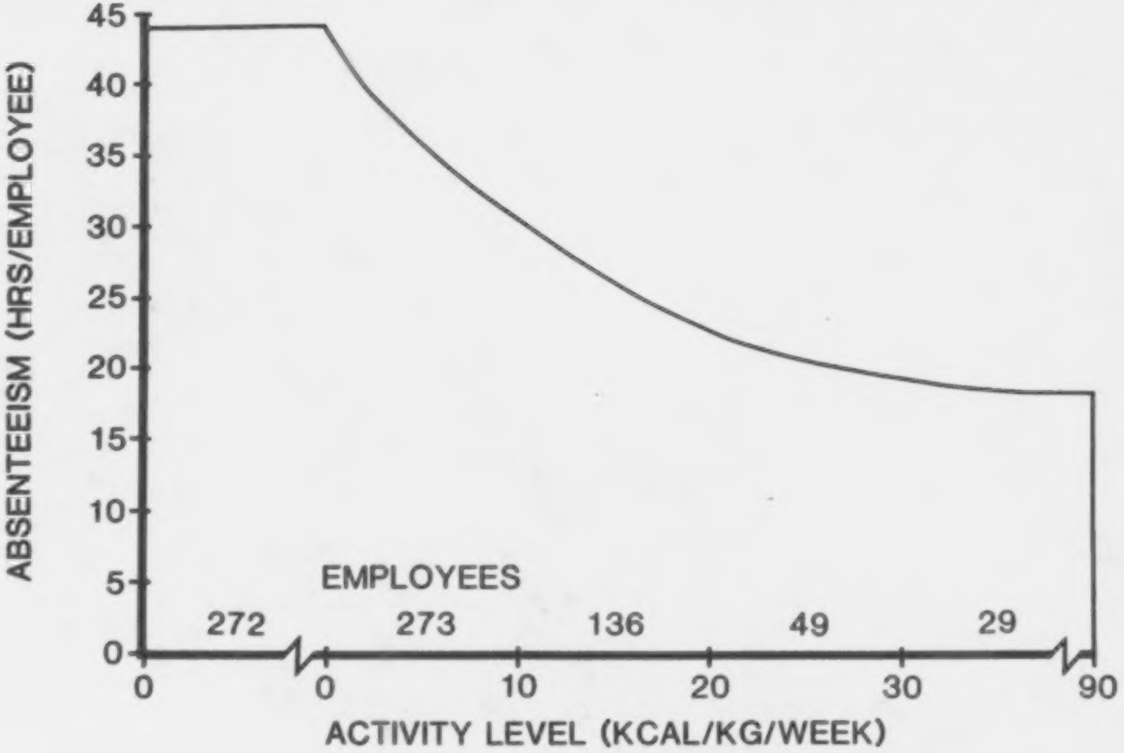
## 1982 MEDICAL COST VS. ACTIVITY LEVEL



Graph #1

## MESA PETROLEUM CO.

1982 ABSENTEEISM VS. ACTIVITY LEVEL



Graph #2

Mr. JENKINS. Would you have any suggestion as to how we might follow your suggestion and clarify the difference between a professionally run operation and a recreational facility?

Mr. GETTMAN. One example would be using American Heart Association guidelines for recommending company wellness programs, or fitness programs. I am currently working with the American Heart Association on that. Simply, No. 1, the program would be goal oriented, with evaluation, including medical and fitness evaluations, exercise prescription and positive living habit components. And number two, the program would provide professionally trained staff with degrees in physical education and/or certification in fitness programs, such as the American College of Sports Medicine provides.

Mr. JENKINS. Would you agree that employees' attitude toward the company would certainly have an impact on their productivity? I guess what I am trying to get to is that I don't disagree so much with what you are saying in regard to the professionally run operation. But I am trying to look at the recreational aspect as well. What about a baseball field or swimming pool or something like that that a company provides? Would you exclude that from that consideration?

Mr. GETTMAN. You have a very good question. I would say that it should not be excluded unless it is part of a purposeful fitness program designed with goals and professional staff onboard. For example, in our program, we have a gymnasium, a track, four racketball courts, and a weight room. We don't have a softball field.

But if we did and it was considered part of our program, then I believe it should be excluded. So it would have to fit within that goal-oriented, professionally run program.

Mr. JENKINS. Mr. Tight, I believe you pointed out that the IRS had not pursued those discounts as compensation. I might suggest the reason they have not is because of the actions of Congress and the moratorium. Would you suggest then that we not pass a piece of legislation in this area? Or in other words, are you willing to let the moratorium expire?

Mr. TIGHT. Well, I would think that any clarification, if any clarification were undertaken, should at least recognize the problems which we have raised in connection with the discounts as they relate to retailing. The bill goes substantially beyond that. As it relates to discounts, it seems to me that discounts are, as I suggested in my testimony, not truly compensation. And therefore, since discounts are more a cost to the employer designed to stimulate sales and for all the other reasons which I have put in, I would suggest that they should not be taxed as compensation.

Mr. JENKINS. I am just curious to know if it is the 20 percent that is bothering you, or the concept that bothers you.

Mr. TIGHT. I think, first, it is the principle that disturbs me. The 20 percent also disturbs me, particularly in our case because we have a substantial amount of our discounts at 30 percent. But I would have to argue to the principle first and to the specifics second.

Mr. JENKINS. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Twenty percent, though, isn't that about normal for most retail establishments?

Mr. **Tight**. Many department stores use 20 percent. Many of the specialty stores, smaller stores, use significantly more than 20 percent. Again, at The Gap we have 30 percent in several different categories of our employees. In the field we use 30 percent as a stimulant to added sales, it is a stimulant at all levels.

Mr. **Duncan**. Would you say a majority uses 20 percent or less or more?

Mr. **Tight**. I don't really have those figures.

Mr. **Duncan**. Mr. Sanders, do you have any information?

Mr. **Sanders**. No; I have no figures on what the majority of retailers use. Our employees seem to think that the majority give more than we do, which is 10 or 15 percent. I hear that voiced once in awhile.

Mr. **Duncan**. I had understood 20 percent was high. But I was wondering about your 30 percent. Could you just facilitate your bookkeeping by reducing it from 30 to 20?

Mr. **Tight**. Of course——

Mr. **Duncan**. Join the rest of the crowd.

Mr. **Tight**. For example at headquarters, we have a 30-percent discount for exempt personnel, both for themselves and their dependents. We have 30 percent for our nonexempt personnel, 15 for their dependents.

This is important because many of the people in headquarters need a greater stimulant to buy Gap merchandise.

Mr. **Duncan**. Of course a lot of times the discount is related to the markup on the product? Isn't that true?

Mr. **Tight**. I think our discount——

Mr. **Duncan**. Discounts related to the markup?

Mr. **Tight**. Well, a discount is off of retail sales, is that correct?

Mr. **Duncan**. Yes, sir. Thank you, gentlemen and ladies. Thank you, Mr. Chairman.

Mr. **Jenkins**. Thank you very much for your testimony.

Our next panel, Employers Council on Flexible Compensation, Mr. William W. Chip, counsel, and the Association of Private Pension & Welfare Plans, Gerald Uslander, vice president, technical support services, Meidinger, Inc. We appreciate very much your coming and giving us your views. Please proceed as you deem appropriate.

## STATEMENT OF WILLIAM W. CHIP, COUNSEL, EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION

Mr. **Chip**. Thank you very much. Rather than read from my testimony I would just like to address a few of the more important points I think should be discussed today. The employers council represents approximately 80 large companies that either have cafeteria plans or are in the process of developing them, so we are obviously very grateful to have an opportunity to talk about a subject so near and dear to our hearts. First I would like to say that there is nothing mysterious about a cafeteria plan. It is nothing more than an employee benefit plan that allows an employee a choice between taxable benefits on the one hand and nontaxable benefits on the other.

The reason why employers offer these types of programs is very simple. There are some benefits like dependent care that people who have children would like very much, and people who don't have children don't want at all. If your spouse is working for an employer who provides health care for the whole family, having your employer provide the same thing for you independently is really a waste of money.

Cafeteria plans make it possible to allow the limited pool of dollars that any employer can commit to employee benefits to be divided up in the most efficient way. These programs have been around since 1972. In 1978 Congress sanctioned them in the Internal Revenue Code with one requirement. That is that the plans not discriminate in favor of highly paid employees.

Now the press release for today's hearing asked for comments on two issues. One issue was whether, when you put all these benefits together into one plan, is there any danger that the employees are going to become confused about which are taxable and which are not, resulting in a compliance problem?

This issue was raised by the Treasury in the Senate Finance Committee hearings. Frankly, we are not really sure what they are talking about. The employee has nothing to say about how his W-2 is filled out. Whether he knows his group term life insurance is taxable or nontaxable is really irrelevant. The employer knows and the employer is the one who fills out the employee's W-2 and withholds tax. So I think the question of employee confusion is really a red herring. I think it is just not a problem.

There is a provision in this bill relating to cafeteria plans which would basically take out all the taxable benefits so that you could no longer offer a taxable benefit in a cafeteria plan, and reduce the nontaxable benefits to a small group of traditional benefits like health care and dependent care. We assume that part of the reason for that is to make it as difficult as possible for the employee to become confused. If you just have a handful of benefits, maybe he is less likely to be confused. We don't think confusion is really an issue so we are not in favor of these changes.

I hope that the committee will consider that this is a change that will cause very serious problems for our members. There are a lot of perfectly legitimate benefits, like life insurance for dependents, which is a taxable benefit if it is above $2,000, which many employees want and for which they are perfectly willing to pay the tax. It is hard for us to understand why this committee would want to exclude taxable benefits from a cafeteria plan. I know there is a lot of concern in this committee and throughout Congress that we don't see a landslide of money in the next two decades into tax-free benefits. But if that is your goal, I would think you would want as many taxable benefits as possible in the plan. If you take out all the taxable benefits, what does the employee have left to choose except nontaxable benefits?

So we hope and believe that the elimination of taxable benefits from a cafeteria plan might have been a mistake. It is really difficult to think of any reason for not allowing them. As far as excluding nontaxable benefits that are not covered by one of three or four code provisions, we imagine there that any confusion has to relate to things like free parking and employee discounts and the items that are only confusing because of the moratorium on fringe benefits regulations. Since this bill is designed to end that confusion, we would assume that this change will not be necessary either.

Thank you.

Mr. Jenkins. Thank you.

[The prepared statement follows:]

## Statement of William W. Chip on Behalf of the Employers Council on Flexible Compensation

### SUMMARY OF COMMENTS

1. *Employee "Confusion"*. Because an employer must report the value of all taxable benefits elected under a cafeteria plan on the employee's W-2, cafeteria plans cannot "contribute to confusion among taxpayers as to what benefits must by included in income".
2. *Discrimination.* Under present law cafeteria plans must provide benefits to all participants on a nondiscriminatory basis and are not "designed to maximize their attractiveness to highly compensated employees to the detriment of low paid employees".
3. *Taxable Benefits.* H.R. 3525 would exclude taxable benefits (other than cash) from cafeteria plans. ECFC strongly opposes this change, which has no evident purpose and which would exclude several popular and valuable benefits from cafeteria plans such as life insurance for spouses and dependents.
4. *Non-taxable Benefits.* H.R. 3525 would also exclude from cafeteria plans any non-taxable benefit not covered by a specific Code provision. ECFC opposes this change, which might needlessly exclude such traditional benefits as vacation from cafeteria plans.
5. *Regulations.* Cafeteria plan legislation should at least be deferred until regulations are issued later this year.

### STATEMENT

The Employers Council on Flexible Compensation ("ECFC") is the national spokesman for the growing number of companies in this country that offer cafeteria plans for their employees. Our membership includes most of the large employers that "pioneered" the flexible compensation concept. A current membership list is attached to our written statement. I believe that the experience of ECFC member companies in actually implementing and operating cafeteria plans gives ECFC a practical and realistic perspective from which to address any concerns this Committee may have on how cafeteria plans operate.

The announcement for today's hearings asked for comments on the possibility of employees becoming "confused" about the taxability of benefits offered under a cafeteria plan and on the possible utilization of cafeteria plans by highly paid employees "to the detriment of low paid employees". I would like to comment briefly on both these matters and then address the specific cafeteria plan provisions of H.R. 3525.

### TAXPAYER CONFUSION

On the matter of "confusion" among employees about the taxability of cafeteria plan benefits, we do not see why there should be any "confusion" about the taxability of a benefit simply because it is offered under a cafeteria plan. However, what is even more important for this Committee to understand is that any "confusion" among employees about the taxability of cafeteria plan benefits is irrelevant. It is the employer, not the employee, who fills out the employee's W-2 and withholds income tax. The penalty for not withholding income tax is quite severe—the employer must pay the tax out of his own pocket. I can assure this Committee that no employer can afford to "confuse" taxable benefits with non-taxable benefits.

### DISCRIMINATION

Your Committee has also requested testimony on whether cafeteria plans are being designed to benefit highly paid employees to the detriment of low paid employees. I would like to point out that every company I have dealt with as an attorney has considered compliance with the nondiscrimination rules under section 125 of the Code to be a critical element of plan design. The penalty for discrimination in cafeteria plans is clear—the highly compensated employees will be taxable on all the benefits received under the plan.

Earlier this year there were some misleading stories in the Wall Street Journal and other publications concerning discrimination in providing dependent care assistance under cafeteria plans. The possibility of discrimination arose because section 129 of the Code, as originally enacted, did not contain a general antidiscrimination rule. This oversight, however, was corrected by the Technical Corrections Act of 1982, which added a strict nondiscrimination rule to section 129. The new rule requires that no more dependent care assistance be made available to highly paid employees than to the lowest paid participant in the plan.

## H.R. 3525

I would like now to turn to the specific changes to section 125 contained in H.R. 3525. Under present law a cafeteria plan may contain three types of benefits: (1) cash, (2) taxable benefits other than cash, and (3) non-taxable benefits. H.R. 3525 would eliminate from cafeteria plans all taxable benefits other than cash and would limit the non-taxable benefits to a limited number of benefits covered by specific provisions of the Internal Revenue Code.

The purpose of these changes is not explained in the Technical Explanation. We assume that their purpose is to limit cafeteria plan benefits to those whose tax status has been clarified by a specific Code provision in order to prevent the "confusion" about which this Committee has expressed concern. If this is the purpose, then I must say that you will be doing a tremendous amount of actual harm to solve a problem that has not been shown to exist.

A typical example of the type of taxable benefit that H.R. 3525 would exclude from cafeteria plans would be group term life insurance for employees and their dependents. As you know, group term life insurance for employees is taxable to the extent it exceeds $50,000, and life insurance for the employee's spouse and dependents is taxable to the extent it exceeds $2,000. Because the employer can often obtain group life insurance coverage at much lower rates then can the individual employee, this is a very popular benefit for employees with families, even though they must pay tax on the benefit. At the same time, this benefit is ideally suited for a cafeteria plan, since employees who have no families generally do not want these benefits and would rather have cash or another benefit instead. Cafeteria plan sponsors are also looking at the possibility of acquiring automobile, home, and other types of insurance at reduced rates for their employees.

If the employee is willing to pay the tax on these benefits, and the employer is willing to make them available, why should Congress prohibit the employees from having them? Moreover, at a time when Congress is searching for additional sources of revenue, it seems counterproductive to exclude from cafeteria plans the very benefits on which tax must be paid.

H.R. 3525 would also eliminate from cafeteria plans any nontaxable benefit not covered by a specific Code provision. Like the provision excluding taxable benefits, this change in the present law might serve to eliminate some highly popular and perfectly legitimate benefits from cafeteria plans. For example, the Internal Revenue Service has ruled that an employee receives a "non-taxable benefit" if he elects to receive an extra week of vacation under a flexible benefits plan. (This is a "non-taxable benefit" that results in no revenue loss to the Government since the employee must pay tax on his vacation pay.) However, because no specific Code provision says that time off from work is not taxable, H.R. 3525 might eliminate the ability to trade off vacation time for other benefits under a cafeteria plan.

## CONCLUSION

We doubt very much that your Committee's intent was to exclude vacation time, dependent life insurance, and other traditional welfare benefits from flexible compensation plans. The tax status of these and many other nonstatutory benefits has been made crystal clear by regulations, rulings, and court decisions. There is no possibility of "confusion" over their tax status. We assume that any concern this Committee may have about confusion over employee benefits must relate to benefits such as free airline passes and merchandise discounts, whose tax status has been left ambiguous by the moratorium on fringe benefits regulations. If this is the case, then the Committee should reconsider the need for cafeteria plan legislation. First, no cafeteria plan with which I am familiar contains this type of benefit. Second, inclusion of this type of benefit in a cafeteria plan would have no effect one way or the other on the employee or employer's perception of the benefit's taxability. Finally, the very purpose of this bill is to eliminate the remaining areas of ambiguity over taxation of fringe benefits, thereby eliminating the possibility of "confusion" in the first place.

We hope that this Committee will be convinced that amendments to section 125 of the Code, which would require most cafeteria plan sponsors to make expensive and unpopular changes in their plans, is not necessitated by the remote and hypothetical possibility of "confusion". Another important consideration against legislation at this time is the absence of cafeteria plan regulations. Section 125 is a reasonably clear and simple provision of the Code. It provides that employees who are given a choice among benefits will be taxed on the basis of the benefits they actually select, so long as the plan is not discriminatory. We are confident that any serious possibility for abusing the cafeteria plan approach can be dealt with by regulations, and we have made a number of concrete recommendations to the Treasury in this regard. Since the Treasury has predicted that regulations will be issued this year, and since there is no evidence of substantial abuse, we submit that any legislation should be deferred until the regulations process has been given a chance to operate.

## EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION

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Mr. JENKINS. Mr. Uslander.

## STATEMENT OF GERALD USLANDER, VICE PRESIDENT, TECHNICAL SUPPORT SERVICES, MEIDINGER, INC., REPRESENTING ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, ACCOMPANIED BY EDWARD DAVEY, EXECUTIVE DIRECTOR

Mr. USLANDER. My name is Gerald Uslander. I am here today representing the Association of Private Pension & Welfare Plans. With me is Edward Davey, the executive director of the association. My written remarks focus on section 2(c) of the bill that deals with the definition of cafeteria benefits, also known as flexible benefits.

I will not read the testimony. Mr. Chip covered many of the points. I will try to cover only those points that he did not cover. We strongly believe that flexible benefit plans are the most efficient means of providing benefits for today's changing work force and that action must be taken now to provide the necessary guidance and encouragement to plan sponsors that wish to adopt or currently maintain flexible benefit plans.

Over the years, Congress has granted favorable tax status to a number of socially useful employee benefits. For example, plan sponsors can now provide life and health insurance programs, dependent care, disability income benefits, and group legal services on a tax-favored basis.

As was said, in 1978, Congress recognized that it no longer made sense to force employers to provide identical benefit programs for each employee. Section 125 of the Internal Revenue Code was enacted to permit employers to offer programs which allowed choice between taxable and nontaxable benefits through the use of cafeteria plans. The modern American work force is considerably more varied today than it was only 10 or 15 years ago. Two wage earner families and women heads of households are particularly likely to have unique benefit needs, and they are just the type of employees whose participation in the work force is growing.

When both spouses are wage earners, it is wasteful for each of their employers to provide health benefits for the family. Similarly, many single people do not need much life insurance. On the other hand, working women with children at home need dependent care.

Flexible benefit programs enable employees to trade unneeded benefits in one area for cash, or for extra benefits in another area. A good number of the programs in existence today allow additional benefits to be bought through salary reduction or salary conversion. As a result, employers can make much broader programs available on a cost-effective and tax-effective basis where they are most needed.

As Mr. Chip said, Assistant Secretary of the Treasury Chapoton in his testimony before the Senate Finance Committee on June 22, expressed concern about the taxability of nonstatutory fringe benefits. Mr. Chapoton feels employees would be confused in thinking they are all nontaxable if they are in a cafeteria plan. If such confusion does exist, we feel it will be lifted by the bill, since its purpose is go give guidance on what nonstatutory fringe benefits will be nontaxable.

Consequently, we feel that since the confusion will disappear with the passage of this legislation, that at least those fringe benefits that fall within the terms of your proposed section 132 be allowed as cafeteria plan benefits. Not only will the confusion as to taxability disappear but these benefits must meet nondiscrimination requirements.

In your request for testimony you asked for comments on salary reduction. I want to spend just a minute commenting on salary reduction as a design element in flexible benefit plans. I will do so very briefly just going over a couple points. The first observation I want to make is that salary reduction is already an established mechanism for funding various kinds of benefits. For instance, the 403(b) annuity is available to employees of certain tax-exempt organizations. These plans seem to work very well.

Another recent area is the 401(k) cash and deferred plan. These are also worthwhile mechanisms for meeting employee needs on a tax-effective basis. A third area where the salary reduction concept is present is in the 414(h)(2) pickup plans which are available to certain Government employees. We are not aware of any controversy surrounding any of these existing salary reduction approaches and we just can't understand why there is so much alarm over the possibility of extending it to cafeteria plans.

The second observation about salary reduction is that it seems uniquely suited to provide benefits which are of great interest to some employees and have no interest to others, for example, dependent care. In the past employers have been reluctant to commit funds to programs that are of such limited appeal. Now, with salary reduction that problem can be overcome. We suspect that the overwhelming majority of all dependent care plans in place today are part of flexible benefit plans and this is a positive development with the changing status of the work force.

Finally, we believe salary reduction is self-limiting in itself and cannot be used to shelter large amounts of money because of the benefits that are provided. You can only spend so much on health and other benefits. It just does not make sense for an employee to spend more than he needs for any particular benefit that would be allowed in a cafeteria plan.

Thank you.

Mr. JENKINS. Thank you very much.

[The prepared statement follows:]

## STATEMENT OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.

Mr. Chairman and Members of the Committee, my name is Gerald Uslander. I am Vice President-Technical Support Services with Meidinger, Inc. I appear before you today representing the Association of Private Pension and Welfare Plans, Inc.

Our Association includes several hundred plan sponsors of all sizes as well as a number of consulting firms, insurance companies, banks, accounting firms, and others associated with employee benefit plans. The Association's interests cover the entire range of employee benefit questions.

My prepared remarks today will focus on Section 2(c) of the bill (H.R. 3525) dealing with the definition of cafeteria benefits, also known as flexible benefits. We strongly believe that flexible benefit plans are the most efficient means of providing benefits for today's changing workforce and that action must be taken now to provide the necessary guidance and encouragement to plan sponsors that wish to adopt or currently maintain flexible benefit plans.

Over the years, Congress has granted favorable tax status to a number of socially useful employee benefits. For example, plan sponsors can now provide life and health insurance programs, dependent care, disability income benefits and group legal services on a tax-favored basis.

In 1978, Congress recognized that it no longer made sense to force employers to provide identical benefit programs for each employee. Section 125 of the Internal Revenue Code was enacted to permit employers to offer programs which allowed choice between taxable and nontaxable benefits. The modern American workforce is considerably more varied today than it was only ten or fifteen years ago. Two-wage earner families and women heads of households are particularly likely to have unique benefit needs, and they are just the type of employees whose participation in the workforce is growing.

When both spouses are wage earners, it is wasteful for each of their employers to provide health benefits for the family. Similarly, many single people do not need much life insurance. On the other hand working women with children at home need dependent care.

Flexible benefit programs enable employees to trade unneeded benefits in one area for cash, or for extra benefits in another area. A good number of the programs in existence today allow additional benefits to be bought through salary reduction or salary conversion. As a result, employers can make much broader programs available on a cost-effective and tax-effective basis.

In his June 22nd testimony before the Senate Finance Committee, Assistant Secretary of the Treasury, John Chapoton, said that allowing nonstatutory fringe benefits or options in cafeteria plans would create substantial confusion about the taxability of such benefits. He feels that most employees would think of cafeteria plan benefits, other than cash, as being all nontaxable.

We know of no specific cafeteria plans that include train passes, college education and other nonstatutory benefits that are the prime subject of H.R. 3525. If such plans do exist, any confusion about the taxability will be lifted by the bill. Its purpose is to give guidance on what fringe benefits that were nonstatutory will be nontaxable.

Consequently, we suggest that since the confusion will disappear with the passage of this legislation, fringe benefits that fall within the terms of proposed section 132 be allowed as cafeteria plans. Not only will there be no confusion as to taxability but these benefits if they are to meet the requirements for nontaxability under section 132 must be nondiscriminatory.

The legislation would also limit taxable benefits in a cafeteria plan to cash. Most Plan sponsors have emphasized statutory nontaxable benefits in designing their flexible benefit programs. Often, the only taxable option included will be cash and salary reduction. These programs would be unaffected by the proposed legislation.

However, there are other programs where additional nontaxable benefits are offered. One important example is group term life insurance. While the first $50,000 of protection is nontaxable, the excess is taxable. This raises the question of Congressional intent as to whether or not this option would be precluded under the proposed legislation.

We urge that group term life continue to be permitted in flexible benefit programs. Those of us who support the concept of flexible benefits feel that life insurance is an excellent candidate for inclusion. Single people need less; family people need more; and flexible benefits are able to meet this need exceptionally well.

Furthermore, there can be no taxpayer confusion as to tax treatment. For many years employers have "imputed" the value of group term life and recorded its net cost on the employees' W-2 statements. While there may well be employees who are not knowledgeable about group term life taxation, there is no problem since the employers have the expertise and do the work.

Indeed, we would ask if this taxpayer confusion issue is truly relevant to flexible benefit taxable options generally. Employers who set up these plans will usually understand the difference between a taxable and a nontaxable benefit. They will be responsible for preparing the W-2 statements and answering any questions these statements may create.

Consider an obscure example of a seldom-offered nontaxable benefit: group auto insurance. An employer who can arrange such a program on a fiscally attractive basis using the power of group purchasing will certainly know that there is no basis for excluding this program from W-2 salary. Hence, even if some of the employees are a little vague on the matter, the employers will be providing an adequate explanation in communications to employees.

Certainly, no great harm would be done if such benefits as group auto were knocked out of flexible benefit plans. However, we question whether this type of creativity should be precluded. There is no evidence of employee confusion on these matters.

One matter that is important to many existing and developing flexible benefit programs is the treatment of vacation options. In today's two wage earner environment, one spouse can often have more vacation time than the other. Hence, the ability to buy or sell vacation days can have a real appeal.

Actually, many employers already permit vacation days to be bought as unpaid leave. Others permit unused vacation days to be sold at the end of the year subject to some limits. Where the employee chooses less pay and more vocation the government collects less tax. Where the employee chooses more pay and less vacation the government collects more tax. This is an established, accepted practice, and we do not see anything wrong with it.

We urge that employees be permitted to use vacation time conversion as a sourse of flexible benefit credits. Similarly, we see no problem in an employee taking excess flexible benefit credits as paid time off.

Today, flexible benefit programs must meet certain nondiscrimination standards for the cafeteria plan as well as somewhat different standards for each of the specific benefits. These standards are intended to insure that the programs benefit employees generally and not just the higher paid. We believe that a single uniform standard can be developed as to eligibility for benefits. Such a single standard would make it easier to establish these types of plans.

We support the use of availability standards for nondiscrimination testing in cafeteria plans, and we applaud your use of it in nondiscrimination testing in the case of your proposed section 132 benefits. Just as it would not be fair to make section 132 benefits available only to the higher paid, it also would not be fair for a cafeteria plan to make some benefits available only to the higher paid.

On the other hand, with the exception for a Section 401(k) plan, it would not be appropriate to apply a utilization of benefits test for cafeteria plans. Let us consider the nature of the decision the employee makes in selecting health coverage and deciding how much to reduce his or her salary to supplement this coverage. It is a decision based on the individual's health, not a tax decision. Employees who anticipate needing coverage will utilize the program more heavily. Employees already covered through a spouse's plan or employees confident of their well-being will probably select a less expensive plan and utilize benefits at a lower level. In any case, their decisions will be triggered by their health needs not their tax bracket.

By contrast, an employee who redirects $100 a month into a section 401(k) cash or deferred arrangement is making a financial decision. To ensure that such a program benefits employees generally, the plan sponsor should measure the actual utilization of the plan by the lower paid. Just such a test is now in place for section 401(k).

If we try to adapt the section 401(k) test to benefits such as health, life and disability under a flexible benefit program, serious problems can be anticipated. Substantial uncertainty exists in predicting the extent to which one employee or a group of employees will draw benefits out of any one of these programs. Furthermore, even where the actual benefit utilization is different for one employee segment than another, it is not necessarily correct to assume that discrimination is at work. Age differences, health condition differences, patterns in choice of physicians or even geographic location differences are major sources of group variations in cost of health care.

Flexible benefit programs are not subject to the same type of income-related usage as are pension plans and other such programs. A $200,000 a year executive cannot typically spend more than twenty times as much money as $10,000 a year worker on such benefits as eyeglasses and other uncovered medical expenses. His health care needs will limit his expenses.

Similarly, the availability of dependent care benefits in a flexible benefit plan will not result in people spending money they do not have to spend.

In other words, these and almost all other cafeteria plan benefits are inherently self-limiting. This lightens the regulatory load substantially. As long as all employees have the benefits available, their needs will determine their usage.

We have also been asked to comment on salary reduction as a design element in flexible benefit plans, even though the proposed legislation does not address this aspect directly.

Our first observation is that salary reduction is already an established mechanism for funding benefits. For many years, employees of certain types of nonprofit organizations have been permitted to use salary reduction to fund section 403(b) annuity plans. These plans work very well we believe. Another more recent example of salary reduction is section 401(k) plans. These are also worthwhile mechanisms for meeting employee needs on a tax-effective basis.

Salary reduction concepts are also present in Code section 414(h), pick-up plans available to certain government employees.

We are unaware of any controversy surrounding these existing salary reduction approaches. Why, we wonder, has this identical technique been reviewed with such alarm for other benefits?

Our second observation about salary reduction is that it seems uniquely suited to provide benefits which are of great interest to some employees and of no interest to others, such as dependent care. In the past, employers have been reluctant to commit funds to programs that are of such limited appeal. Now, with salary reduction, that problem can be overcome.

We suspect that the overwhelming majority of all dependent care plans in place today are part of flexible benefit plans. This is a positive development. America must meet the needs of working women and single parents if we are to get the maximum contribution from this valuable and important segment of the workforce. Flexible benefits have proven to be an important tool in this area.

Our final observation about salary reduction is that it cannot be used to shelter large amounts of money because of the benefits that are provided. No matter how rich or how tax-conscious we may be, there is no point in spending one's money on unnecessary health care or dependent care or life insurance. People can buy hundred thousand dollar tax shelters, but they cannot buy hundred thousand dollar uncovered medical benefits or child care programs.

In summary, we believe flexible benefits will serve America well. These programs can help employers control costs. They can help employees satisfy their unique and increasingly divergent benefit needs.

Many employers view flexible benefits as an opportunity to reassess their plan design in light of the realities of the 1980's. These reassessments not infrequently result in the injection of increased deductibles, coinsurance or employee contributions into the health benefit. These changes are designed to increase employee involvement in the costs of his benefits, and to get away from the first dollar coverage mentality.

Congress should continue to ensure that these programs fulfill their purpose of benefitting employees generally. We strongly recommend that the scope of taxable and nontaxable benefits that may be included in a cafeteria plan not be unnecessarily restricted. We also agree with you that availability standards rather than utilization standards be relied upon.

Thank you for the opportunity to testify today. As the Committee considers the area of flexible benefit plans, we hope that we can be of assistance to you and your staff in the development of the proper environment to encourage the use of such plans.

**Mr. JENKINS.** I wonder if you could tell us from your experience, to what extent are taxable fringe benefits utilized in cafeteria plans today.

**Mr. CHIP.** Taxable fringe benefits?

**Mr. JENKINS.** Yes.

**Mr. CHIP.** I would say that certainly group term life insurance over $50,000, which is taxable, and dependent life insurance, which is taxable when it is over an incidental amount, which I believe the regulations define as $2,000, are probably found in almost every major cafeteria plan.

**Mr. USLANDER.** In many of them there are also vacation benefits, either purchasing additional days or trading in days for credits where they are needed in other benefits.

**Mr. CHIP.** This is really the exciting area of cafeteria plan development. Employers are finding that in things like group automobile insurance, group liability insurance, even group homeowners insurance, they can get for their employees substantially reduced rates over what the employee could get in the marketplace himself.

If the employer is willing to go to the trouble of getting this reduced rate coverage and the employee is willing to pay the tax on it, it is hard to understand why you wouldn't want to allow the employer to do this. I mean there is no revenue loss to the Government.

In fact, there is a revenue gain because he is probably giving up a nontaxable benefit to get this benefit.

**Mr. JENKINS.** Mr. Duncan.

**Mr. DUNCAN.** I have no questions. Thank you, Mr. Chairman.

**Mr. JENKINS.** Gentlemen, thank you very much for your testimony. This concludes the hearing, and we appreciate the testimony. Thank you very much.

[Whereupon, at 1:55 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Air Line Pilots Association,
*Washington, D.C., August 4, 1983.*

Hon. Fortney H. Stark,
*Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives. Washington, D.C.*

Dear Mr. Chairman: On behalf of the Air Line Pilots Association (ALPA) which represents the professional interests of more than 36,000 airline pilots who are employed by 46 air carriers in the United States, I am pleased to have the opportunity to present our views on the issue of the taxation of nonstatutory fringe benefits and particularly H.R. 3525, the Permanent Tax Treatment of Fringe Benefits Act of 1983.

At the outset, I wish to commend you, Mr. Chairman, and your colleague Mr. Conable for introducing H.R. 3525 and holding this hearing on the bill. For several years ALPA has advocated the enactment of legislation such as this to settle permanently the controversy surrounding the tax treatment of nonstatutory fringe benefits. We view your initiative as the necessary first step in a process which we hope will culminate in the passage this year of a bill that will provide certainty to the IRS and taxpayers alike in this unsettled area. Given the fact that the Congressional moratorium on the promulgation of fringe benefit regulations by IRS expires at the end of this year, we are hopeful that the Committee on Ways and Means will move expeditiously on this legislation. Absent the time or conditions necessary to enact a bill by December 31st we would support the extension of the moratorium so that a reasoned and comprehensive approach to this matter can be taken.

Mr. Chairman, ALPA believes that the method proposed in H.R. 3525 for the tax treatment of nonstatutory fringe benefits is fundamentally sound and equitable; however, we recommend three specific amendments for consideration by the Committee.

First, H.R. 3525, as drafted, restricts nontaxable status to fringe benefits provided to an employee exclusively by his or her own employer. As the Committee knows, it has been a customary practice in the airline industry for many years for one company to make free and reduced-rate travel benefits available to the employees of another company pursuant to a so-called interline agreement authorized by the Federal Aviation Act of 1958. Under the bill, such interline travel benefits would not be excluded from tax treatment as gross income. Inasmuch as these reciprocal benefit arrangements have been customary industry practice for decades, we would urge the Committee to amend H.R. 3525 to give them the same tax status as the bill gives to benefits provided directly by one's own employer.

Second, the bill provides that use of any fringe benefit which qualifies as a "no-additional-cost service" or a "qualified employee discount" by a spouse or a dependent child of the employee shall be treated as use by the employee. Airline travel benefits are commonly made available to other members of an employee's family besides his or her spouse and dependent children. In most cases the employee's parents are eligible for such benefits particularly if the employee is single. In light of this traditional practice we would urge the Committee to treat parents of the employee in the same manner as the bill treats the employee's spouse and dependent children.

Finally, it has been a customary practice in our industry to make travel benefits available to the surviving spouse of a deceased employee who has had a certain number of years of service with the company. In its present form H.R. 3525 would not exclude from gross income benefits provided to a surviving spouse, and therefore, we would request that the Committee consider an amendment to continue this traditional practice.

In conclusion, Mr. Chairman, ALPA strongly supports H.R. 3525 with the amendments outlined above. Again, I want to comment you and Mr. Conable and your staffs for developing this legislation, and we at ALPA look forward to working with you to enact this bill and thus clarify the tax treatment of nonstatutory fringe benefits.

Sincerely,

Henry A. Duffy, *President.*

NEW ORLEANS, LA., *August 12, 1983.*

Re H.R. 3525.

To: John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

From: Tulane University Chapter of the American Association of University Professors.

The Tulane University Chapter of the American Association of University Professors wishes to go on record as approving the provision in H.R. 3525 that tuition remission programs at home institutions where this benefit is awarded on a non-discriminatory basis be non-taxable.

The Chapter also wishes to register its dissatisfaction with the exclusion from non-taxable status of (a) tuition exchange and tuition grants for study at other institutions, and (b) tuition remission for graduate study.

In making the tuition exchange and tuition grants to other institutions taxable, we believe the drafted legislation unwarrantedly restricts choice of study and limits the advantages of enrollment in college away from home to dependents of highly compensated employees. In institutions which provide such benefits, lesser paid employees would not be able to avail themselves of these benefits. Although they may have planned to manage the expense of travel, room, board, and other costs on their usual income during the years when the dependent is away in college, the imposition of the tax on an income inflated by the amount of the tuition grant would very likely make the total cost prohibitive. This situation is particularly marked for families with two or more dependents in college concurrently. If away from home, the taxable income would be increased by the tuition amount for all children. In such cases, a decision might have to be made that one but not all would have a choice of school.

Under these circumstances of additional financial constraint, the choice of study is limited to programs offered at the home institution. The disadvantage is illustrated in the example of a dependent who wants to study engineering or architecture, neither of which is offered at the home institution. Such a restriction could lead to the decision not to go to college or to drop-out later. Either case would be a loss.

In addition, the provision for non-taxability only on tuition remission at the home institution could be sex or race discriminating. Employees in "black colleges" would get a tax break only if their children went to that "black college." Similarly, employees in non-coed institutions would get a tax break only for their children of the sex accepted at that institution.

With respect to taxable tuition remission for graduate study, we believe that this would also be discriminatory against lesser paid employees. It means that a number of persons who were able to enter graduate study because this benefit was available without taxation prior to June 30, 1984, and who will not have completed their program by that date may have to drop out. Making this benefit taxable may also deprive a number of highly qualified persons from doing graduate study in the future. It is to be pointed out that other sources for financial aid for graduate study provided by educational institutions and the state and local governments have been drastically cut in the last few years. This provision in the bill represents another form of cut for graduate education.

By providing employees a non-taxable benefit in the form of tuition remission programs, whether at the home institution or at other institutions, private and state institutions are helping to underwrite the cost of educating the nation's population. It is doubtful that the gain in federal revenue resulting from taxing tuition exchange and tuition grants for individual recipients would offset the loss to the nation in the number of persons who could no longer afford higher education.

We hope that the concerns expressed here will be helpful in arriving at equitable legislation which we believe would include tax exclusion for tuition exchange and tuition grant benefits at both the undergraduate and graduate level along with the proposed exclusion for tuition remission at the home institution.

AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS,
WITTENBERG UNIVERSITY CHAPTER,
*Springfield, Ohio, August 10, 1983.*

Re H.R. 3525.

Mr. JOHN J. SALMON,
*Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.*

DEAR MR. SALMON: On behalf of the Executive Committee of the Wittenberg University Chapter of the A.A.U.P., I am writing to express concern about the failure of H.R. 3525 to acknowledge that tuition exchange and tuition grants programs are scholarships as defined in section 117 of the Internal Revenue Code.

It is clear that tuition remission programs, including tuition exchange and tuition grants programs, meet the test for scholarships under section 117: (1) they are not compensation for services; (2) the recipient is not performing substantial services, research, or studies on behalf of the granting institution; (3) the purpose of the scholarship is not for the benefit of the granting institution.

Essentially these programs are not compensation to faculty members, but are scholarships for which the dependents of faculty become eligible only after they have met the admission standards of an institution of higher learning. Moreover, there is no compensation in lieu of tuition remission programs for those faculty members who have no dependents who utilize them.

We strongly urge that H.R. 3525 include tuition exchange and tuition grants programs as scholarships and not as taxable fringe benefits.

At this time when the very quality of American higher education is questioned, additional erosion of scholarship opportunities will only further undermine the future of this important institution and of our country.

Sincerely,

KENNETH L. SCHEFFEL,
*President, Executive Committee.*

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## STATEMENT OF NORMAN SHERLOCK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BUS ASSOCIATION

### SUMMARY

As the national trade association for the intercity bus industry, the American Bus Association, on behalf of its nearly 3,000 member organizations, would like to express the bus industry's opposition to H.R. 3525, The Permanent Tax Treatment of Fringe Benefits Act of 1983.

The ABA endorses a legislative rather than a regulatory or judicial definition of what fringe benefits do or do not result in taxable income to employees. However, H.R. 3525 in its present form is not, we believe, an appropriate solution to the problem.

We oppose this bill for several reasons:

1. Taxing bus drivers on courtesy transportation provided by non-employer bus lines would be grossly unfair to those drivers whose routing begins away from their permanent home base.
2. Limiting reduced-fare passes to the employer bus line would unfairly discriminate against small bus lines and would be impossible to value.
3. The bill does not foreclose the Internal Revenue Service from taxing fringe benefits provided by an employer which fringe benefits would have been deductible if paid directly by the employee.

### STATEMENT

H.R. 3525 would be devastating for bus drivers who use courtesy transportation from their home base to the initial point on their bus route. Bus drivers are limited by federal regulation in the number of continuous hours they may drive each day. When a bus route requires a transit time in excess of the permitted number of continuous driving hours, bus lines must send drivers out ahead of a particular bus to prevent a delay in service. With respect to charter operations, these drivers are often sent ahead on scheduled bus lines. The scheduled bus lines often provide this transportation without charge to the drivers on a space available basis. This courtesy transportation is similar to the interline passes of the aviation industry. Because the origination and destination points of charter busses differ with each charter, it is impossible for the drivers to move to the point at which their route begins so as to reduce their commute.

To tax a bus driver for his travel from the bus line's home base to the state of his particular route is unfair as this particular "fringe benefit" is necessary for the bus driver to be able to perform his duties. It would be inequitable to force a bus driver to pay a tax on traveling from his home base to where his drive will begin while an executive pays no tax on his office.

Second, limiting the tax free treatment of reduced fare passes to the employer bus line unfairly discriminates against small bus lines and charter bus lines. If an employee of a regional line wishes to use his reduced fare pass to travel, he will only be able to go as far as the line goes, while an employee of a national company could go anywhere.

In addition, the reduced fare passes are generally given only on a space available basis. From an economic perspective, such space available passes are incapable of valuation. An empty bus seat is an economic service lost forever while filling that same bus seat will be a small additional burden on the bus line. Furthermore, how is it possible to value a bus seat that no one wanted to purchase at the price offered by the bus line? Is the value of that seat the amount which would have lured one more passenger onto the bus? Or is the value the lowest paid by any riding passenger (presumably the price needed to lure that last passenger onto the bus)?

Furthermore, bus lines have a business purpose for providing reduced fare passes in addition to benefiting its employees. It is obvious that bus lines compete with air travel for transportation services to numerous areas. Some member of the public perceive bus travel as inferior to air travel. This perception can only be exacerbated if bus line employees choose to travel by air instead of by bus. Reduced fare bus passes are thus used by bus lines to promote the image of bus travel to the general public by showing that bus employees prefer bus travel to air travel.

The third problem with the bill arises from how the bill might be interpreted rather than from its actual language. Traveling expenses incurred by employees are currently deductible under specific code provisions such as 26 U.S.C. § 162(a) (2). These expenses are ofter paid by the employee who is then reimbursed by his employer. Assuming that traveling expenses are not disallowed under some other specific provision, they will have no tax affect on the employee who has both income and a corresponding deduction. The bill as drafted would specifically protect the employee's deduction in these circumstances.

As an alternative to reimbursing the employee, employers often pay the travel expenses directly. In this case, the employee currently has no tax effect because he has no income and no deduction. Under the bill, such traveling expenses could constitute a "working condition fringe". However, it is also possible for the Internal Revenue Service to find that such employer-paid traveling expenses do not constitute a working condition fringe and do constitute taxable income to the employee. If the IRS takes that position, the employee has not incurred any expense related to that income and would therefore not be entitled to a deduction corresponding to the income. The unfairness of taxing an employee solely because his employer paid his traveling expenses directly is obvious. Any fringe benefit legislation should provide clearly and specifically that any benefit which would have merited a deduction if paid directly by the employee will not be a fringe benefit producing taxable income.

With respect to the bus industry, the potential effect of taxing "traveling expense" items which are provided for free to the employee would be crushing. Both charter and scheduled bus lines provide for meals and lodging when the routing requires an overnight layover of a bus driver. In addition, as a means of enticing bus lines to reserve the large number of rooms required by an overnight charter, hotels often provide free rooms for the bus driver and escort on the particular charter. It would be grossly unfair not to clearly preclude the taxation of this particular practice.

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American Chemical Society,
*Washington, D.C., August 19, 1983.*

Hon. Fortney Stark,
*Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.*

Dear Mr. Chairman: I am writing to you today on behalf of the American Chemical Society to comment on your bill, H.R. 3525, the Permanent Tax Treatment of Fringe Benefits Act of 1983. The bill mandates that fringe benefits received by an employee from his or her employer be considered part of the employee's gross income, unless the benefit qualifies for exclusion under the bill itself or under a specific statute in the Internal Revenue Code. Our comments are limited to one type of fringe benefit: employer-provided educational assistance.

We realize that for the moment, benefits received under qualified employee educational assistance programs are specifically excluded from taxation under Section 127 of the Internal Revenue Code. However, we also note that this exclusion is scheduled to terminate on December 31, 1983. The Society favors making the exclusion for employee educational assistance permanent, as provided in legislation introduced by Senator Packwood (S. 249) and Congressman Shanon (H.R. 2568). We hope that your bill might be amended to reflect this view. Our reasons are as follows.

First, H.R. 3525 excludes from taxation certain tuition reductions for employees of educational institutions and their immediate families. Thus, the bill already recognizes the principle that educational assistance programs are different from other fringe benefits, such as use of a company car, or discounts on merchandise. Given that your bill already recognizes this inherent difference, we suggest that its scope be expanded to include all employer-provided educational assistance.

Continuing education programs, for example, are extremely important for a variety of reasons, the major one being that they allow technically-trained members of the workforce to keep up-to-date on the latest developments in their fields. Keeping up-to-date enhances their skills and efficiency, thereby helping to increase the productivity of the firms for which they work, and thus the productivity of the nation.

Another point to consider is that employee educational assistance programs help entry-level employees in their careers by preparing them for jobs of greater responsibility. This is particularly important in the case of employees who have been educationally disadvantaged or deprived. In short, employee educational assistance programs help promote equality of opportunity. It is our view that programs promoting this fundamental American value should not be taxed.

We also note that there has been a tremendous rebirth of public interest in assuring quality in education, particularly in mathematics and the sciences. The public has realized that quality in science and math education is vital to our long-term national interests, and Congress has responded in a commendable manner to this justifiable concern. Given this situation, it is inconsistent on the one hand for Congress to appropriate large sums to support science and math education, while taxing employee educational assistance programs on the other. The Society believes that this inconsistency can and should be corrected by keeping tax policy in agreement with the goals of the rising national concern over the state of American education.

Finally, according to a recent report prepared by the staff of the Joint Committee on Taxation, revenues accruing to the federal government as a result of including employee educational assistance in the federal income tax and FICA tax bases would be less than $50 million per year in both cases. This is a relatively small amount of money, especially when one considers the adverse effect taxing such programs would have on the quality of the nation's workforce, with its corresponding adverse effect on the national economy.

For all these reasons, we hope that you will amend your bill to make the statutory exclusion for employee educational assistance programs permanent.

In the event that you are not familiar with the American Chemical Society, it is a nonprofit scientific and educational organization with a membership of over 126,000 chemists and chemical engineers. The Society spoke out on this issue once before, in 1978. We hope your subcommittee finds the above comments helpful in its deliberations.

Sincerely,

FRED BASOLO, *President.*

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## STATEMENT OF PHYLLIS H. GERSTELL, SENIOR COUNSEL, AMERICAN COUNCIL OF LIFE INSURANCE

The following comments on H.R. 3525 are offered on behalf of the American Council of Life Insurance ("ACLI"). The ACLI represents 577 life insurance companies which, in the aggregate, have 96 percent of the life insurance in force in the United States and hold 97 percent of the assets of insured pension plans.

The ACLI supports the intent of H.R. 3525 to create certainty and end inequity with regard to the tax treatment of employee fringe benefits. Moreover, we support the bill's realistic and fair confirmation of the continued nontaxability of many traditional fringe benefits.

There are, however, certain specific provisions in the bill which we believe need further clarification. These provisions are outlined in our comments below.

### 1. QUALIFIED EMPLOYEE DISCOUNT

Under the bill, discounts provided employees and their immediate families are excluded from gross income so long as the discount is no more than the lesser of (a) 20 percent of the selling price, or (b) the employer's profit percentage. This rule may be reasonable in the context of a retail or service establishment; it simply does not work when applied to the discounts typically offered by life insurance company employers to their employees.

The usual discount offered life insurance employees who purchase insurance is equal to the first year's agent's commission—which can represent up to 50 percent or more of the first year premium. But it is important to bear in mind that this seemingly large discount is a one time affair, occuring only during the first year of the contract's issue. Since life insurance is a product which provides its benefits over a period of many years, a first year discount of 50 percent, if amortized over the expected life of the contract, would more properly be reflected as a much smaller percentage of the selling price of insurance. But under the bill's proposed employee discount rules, no explicit provision is made for discounts which, as in this case, need to be amortized over time.

Similar progblems arise when life insurers attempt to measure their profit margin for purposes of the "lesser of 20 percent or profit" test embodied in the bill. Again, life insurance is a product sold over time and thus true profit can only be assessed retrospectively, after mortality, investment and interest experience have been determined. Attempting to currently derive the profit made in any one year on a particular life contract would be both an artificial and meaningless exercise in speculation.

Because of these problems created by the "20 percent or profit" rule, we suggest that the qualified employee discount provision be eliminated. We believe that a proper test for employee discounts should parallel the bill's proposed "no-additional-cost service" rule, and would provide an income exclusion for items offered at a discount to employees if the items are generally provided in the employer's normal business and the discount creates no substantial additional cost to that employer.

If, however, the Subcommittee wishes to retain the 20 percent test, we suggest that the test be modified to take into account situations where the total cost of the discount item is paid for over more than one year. Under such a modified test, where the cost of a discount item is paid for in installments over more than one year, the 20 percent limit would be applied to total anticipated cost.

### 2. WORKING CONDITION FRINGE

We believe that the rules relating to parking fringe benefits need further amplification. Under the bill, free or reduced parking is treated as an excludible fringe benefit only it it is provided on substantially the same terms to each member of a group of employees defined under a reasonable and nondiscriminatory classification.

The ACLI believes these provisions should be expanded to indicate that parking assignments made on the basis of seniority or on the time of application for space would not be deemed to discriminate in favor of the prohibited group. This would take into account the practice, common in many industries, of assigning spaces closest to the main building to senior executives. We believe this practice is justified when one considers that the working hours of senior executives often extend beyond the routine day, and that such executives often need to be available on an urgent basis. The bill should specifically indicate that distinctions in proximity of parking space, where justified by work patterns, need does not violate the nondiscrimination requirement for working condition fringes.

### 3. AFFILIATED COMPANIES

Under state law, casualty and life insurance must be written in separate corporations. It is quite typical, however, for an insurance company to encompass both a casualty and life insurance affiliate, with employees of each company allowed to purchase the affiliate's product at a discount. Under the proposed bill, it is unclear whether discounts between such affiliates would be excludible from gross income.

As stated in the Joint Committee Report accompanying the bill, goods or services for which either the 20 percent discount or the "no-additional-cost" discount are available must be those offered for sale by the employer "in the ordinary course of the employer's trade or business in which the employee works." In the affiliated insurance company context, it is unclear whether this language would exclude employees of the life insurance affiliate from receiving a discount on the products of the property/casualty affiliate. If one assumes that in both cases each affiliate is in the trade or business of "insurance", then the inter-affiliate discount would be permissible under the proposed rules. The rules provide, however, no guidance as to how broadly or narrowly the term "trade or business" is to be interpreted.

The ACLI believes that any definition of "trade or business" for purposes of the fringe benefit bill should be a broad one. This is particularly relevant in light of current provisions in the bill which allow discounts between employees of one entity with regard to products sold by a leased department within that entity. We see no reason for treating leased departments more favorably than affiliated companies and therefore suggest that the final Committee Report language accompanying the bill should clearly indicate that "trade or business" is to be given a broad definition. So long as the discount being considered otherwise falls within the "no-additional-cost" or "less than 20 percent or profit" limits, there seems adequate prevention against any potential abuse or unfairness.

### 4. COMPUTATION OF IMPUTED INCOME

Where fringe benefits do not fall within one of the bill's excluded categories, the Joint Committee Report indicates that the benefit is to be taxable at the excess of its fair market value over any amount paid by the employee for the benefit. We believe that this valuation should be changed to specify that includible benefits should be valued at the lower of the employer's cost or fair market value.

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## Statement of the American Hotel & Motel Association

The American Hotel & Motel Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico and the Virgin Islands, having a membership in excess of 8,200 properties accounting for over one million rentable rooms. Inclusive in our membership are all of the major hotel and motel chains.

The Federal tax treatment of fringe benefits is of concern to the hotel/motel industry both as an industry that employes a large number of employees and as an industry with its own specific types of benefits that are not easily covered by general rules and regulations.

The lodging industry is a varied business, providing both goods and services to customers. It is organized as corporate chains, independents, mom and pops, small and large businesses, franchise and nonfranchise, associations, partnerships, sole-proprietorships, etc. Thus, labor intensive and complex, the industry is concerned that general rules on fringe benefits could disproportionately and adversely impact it. In general, the industry feels that an employer should be able to share with his employees a reasonable portion of facilities, goods and services that are part of the employer's business, without the employee receiving compensation includable in taxable income if there is no substantial cost incurred by the employer.

In the lodging industry, meals and lodging provided for the convenience of the employer are excluded from income. The tax laws have recognized that these types of working conditions are not to be taxed because they are provided by the employer for substantial noncompensatory reasons. It is in the non-statutory area that the law has been unsettled.

H.R. 3525 excludes from taxation benefits that qualify under any one of four categories:

### NO ADDITIONAL COST SERVICE

Under this category, the entire value of any no additional cost service provided by an employer to and for the use of an employee (or employee's family) would be excluded from income but only if the service is provided to employees on a nondiscriminatory basis. The example that is used in the explanation of the bill is stand-by airline travel. A similar application of this rule to the lodging industry would be difficult. To begin with, this category says that the service must be of the same type which is provided to the public. A hotel or motel provides many things to the public: rooms, food, and the use of facilities. A hotel company may provide discounted rooms or food to its employees, and may allow for the purchase of discounted goods or the occasional use of some facilities. A hotel or motel is not just in the business of providing rooms.

In addition, it would be very difficult to determine whether the employer had incurred any substantial additional cost in providing the benefit. Rooms, for example, may be discounted to the general public for many different reasons. At times employees are extended discounts that may not be as low as those available to the public.

Finally, most hotel/motel companies who provide discounted rooms to their employees do so on a space available basis. Such a basis is similar to, but not the same as, a stand-by seat on an airplane. An employee could not be expected to travel a long distance to a hotel or motel in the hope that a stand-by discounted room awaited him. Thus, whether an individual hotel or motel incurred a cost in providing a discounted room to an employee could often not be determined until after the employee stayed in the room. If the hotel was fully occupied, the room may not be available to the employee on a discounted basis. It does not seem fair to include in the employee's income an amount the employee did not anticipate. Therefore, any general rules on fringe benefits should allow, in the calculation of the cost of the room, the value of the room at the time the employee reserved it.

It is important to remember that hotels and motels are businesses. The discounting of rooms to employees, although important to some companies in terms of employee relations, is secondary to the primary objectives of providing service to customers and making a profit. Employers determine what is good compensation to employees but in addition do not lavish meals and lodging on them to the detriment of their business or for the sole purpose of avoiding the tax laws. Employers in the lodging industry, we reiterate, feel that with careful planning they can provide employees a share of the goods, services and facilities of the industry at no substantial additional cost to employers.

### QUALIFIED EMPLOYEE DISCOUNT

Under this category, qualified discounts allowed to an employee (or employee's family) from the selling price of the employer's goods or services would be excluded up to 20 percent of the selling price for tax purposes. The excludable amount of the discount would be limited to the lesser of: (1) 20 percent of the price to which the goods or services are offered to nonemployee customers by the employer or (2) the employer's profit percentage, as defined in the bill. The employer's profit percentage is defined as the amount by which the aggregate sales price for the year of property or services sold by the employer exceeds their aggregate cost to the employer, divided by the aggregate sales price.

This is a complicated formula for employers to utilize in situations where discounts are given. The bill says that discounts would be allowed up to 20 percent of the selling price but in the lodging industry, the "selling price" of a room is not, as mentioned above, a simple matter. Different rooms are discounted to the public at different times for different reasons. For example, there are convention rates, seasonal rates, government rates, discount for the clergy and many other types of business discounts. Secondly, using the employer's profit percentage with the aggregate figures it entails is more suited to goods than services. Excluding from income a discounted room based on an annual aggregate figure bears no relationship to the value of cost of the room at the time the employee is using it. The employee discount should not be limited to any specific percentage of normal retail price.

### WORKING CONDITIONS

Under this category, the fair market value of property or services provided primarily for the purpose of facilitating the employee's work for the employer would be excluded for tax purposes. The bill states that this working condition exclusion would apply, however, only if substantially all (at least 85 percent) of the use of the property or services reasonably can be expected to occur in connection with the employee's performance of services, i.e. for business purposes.

Again, it appears to us that this category of usage applies more to the use of goods or property rather than the use of a service. For example, if an employee traveled to a hotel on business and stayed four days for business reasons but stayed one more day for personal reasons, the employee would have used the room for personal reasons twenty percent of the time (one day of five) and thus the use of the room would not be excludable from income under this category as defined by the bill.

### CAFETERIA PLANS

H.R. 3525 would exclude taxable benefits (other than cash) from cafeteria plans and would also exclude any nontaxable benefits not covered by a specific code provision. We oppose this piece-meal approach to dealing with cafeteria plans. Certain traditional benefits, such as life insurance for spouses and dependents and even vacations, might be affected.

### SUMMARY

Although H.R. 3525 is a good effort toward solving many of the fringe benefit problems, the American Hotel & Motel Association is concerned that the legislation could unfairly restrict those benefits provided to employees at no substantial additional cost to hotel/motel employers. Final fringe benefits rules should be flexible and recognize the unique aspects of the lodging industry.

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AMERICAN RETAIL FEDERATION,
*Washington, D.C., August 1, 1983.*

Mr. JOHN R. SALMON,
*Chief Counsel, House Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.*

DEAR MR. SALMON: Enclosed is a statement on behalf of the American Retail Federation on H.R. 3525, the Permanent Tax Treatment of Fringe Benefits Act of 1983.

The American Retail Federation is a federation of state retail associations in all 50 states and the District of Columbia, and 32 national retail associations. Their membership consists of a wide variety of retail stores, ranging in size from small neighborhood retailers to large national chains. Through its members, the Federation represents well over one million retail establishments, which employ over thirteen million workers.

I would appreciate it if the statement and transmittal letter be made a part of the hearing record on H.R. 3525.

Sincerely,

LOYD HACKLER, *President.*

Enclosure.

### STATEMENT OF THE AMERICAN RETAIL FEDERATION

The American Retail Federation is opposed to the treatment for tax purposes of employee discounts contained in H.R. 3525. In this regard we firmly support and are in agreement with the position taken in testimony submitted and presented today on behalf of the National Retail Merchants Association (NRMA). The bill is contrary to American Retail Federation's position that employee discounts serve essential and vital employer interests and are a non-compensatory benefit that should not be subject to federal income taxation. Moreover it is the position of the American Retail Federation that H.R. 3525 unfairly discriminates against employees of retail establishments. There is simply no rational basis for the 20 percent limitation. The 20 percent limit is arbitrary and discriminates against employees of retailers. In addition, H.R. 3525 would present a massive administrative burden for the nation's retailers, particularly for small retailers who do not have access to sophisticated computer systems.

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### STATEMENT OF THE AMERICAN SOCIETY FOR TRAINING AND DEVELOPMENT

The American Society for Training and Development is pleased to make comment on H.R. 3525 since we represent those professionals in the workplace who primarily administer employer-employee education and training programs. We have nearly 50,000 members in our national organization and in the 138 chapters throughout the country. Our members provide extensive human resource development services from remedial basic education for entry-level employees to on-going job skill development for millions of employees to cope with the ever-changing needs of the workplace.

Our comments deal specfically with "Working Condition Fringe" section. We are pleased that job training (the acquistion of job knowledge and skill) seems to be covered as "services which are provided primarily for the purpose of facilitating the employee's performance of service for the employer. . ." We feel that on-the-job training is a noncash item provided by the employer that is so closely connected with the employee's performance of his job that the items would not be considered compensation and therefore not be taxed.

Taxing on-the-job training would be a serious regressive tax and in direct conflict with our national economic interests. We are pleased the bill's authors included provisions for exclusions of "working condition" fringes in H.R. 3525.

## STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

AGC supports legislation to permanently prohibit the issuing of regulations governing the general taxation of fringe benefits. AGC opposes legislation which would make the value of fringe benefits subject to income tax, social security taxes, and unemployment taxes. In the event Congress does impose taxes on the value of fringe benefits AGC is opposed to any measure which would either deny deductions to employers providing such benefits or which imposes an employer level tax on the value of the benefits.

The provisions of H.R. 3525 exempt many of the ordinary fringe benefits found in the construction industry from taxation. However, the bill also effectively imposes taxation on other fringe benefits. We have not had sufficient time to fully assess the far reaching effects of the legislation and we therefore recommend that industry be given time to fully review the legislation and present their views in additional public hearings. We offer the following preliminary comments on the legislation pending a more thorough study.

### QUALIFIED EMPLOYEE DISCOUNT

H.R. 3525 would allow an employer to offer employees a discount on goods offered to the general public. A discount of 20 percent is permissible unless the percentage exceeds the employer's profit margin. In the construction industry it is common for construction contractors to sell used equipment and tools when a project is completed. If a firm has a sufficient inventory of such items available they are generally offered for sale to the public. Employees are often given discounts on purchases. However, if a contractor does not have a sufficient quantity of items to justify sales operations to the general public he may well sell tools and used equipment to a wholesaler. We see no reason for denying the contractor the option of selling all or part of the items to employees at prices below that paid by a wholesaler. Our analysis assumes that sales to wholesalers on an infrequent basis would be deemed not to be sales in the ordinary course of business as defined under "qualified property or services".

The determination of a profit margin will also be difficult in many instances. We suggest that a percentage discount alone be used to determine whether the discount is subject to taxation.

### PARKING

Free parking should not be treated as a separate category of working condition fringe benefit. The requirement that parking be offered to all employees in a nondiscriminatory manner fails to recognize that certain employees such as sales representatives need ready access to transportation as a working necessity.

### PERSONAL AUTOMOBILE USE

The technical explanation of H.R. 3525 allows an employee the use of an automobile as a working condition only if his personal use of the vehicle does not exceed 15 percent. The use of automobiles can be apportioned easily and we can see no justification for excluding the value of an auto from an employee's income if personal uses amount to 15 percent or less but including it in income if personal use amounts to 16 percent or more.

### EFFECT ON EXISTING NONSTATUTORY RULES

The legislative implication of H.R. 3525 is that every fringe benefit not specifically covered in the act or in other provisions of the Internal Revenue Code should be subject to tax. We suggest that the legislation be amended to make clear that prior case law and rulings are not affected by the legislation and that the Treasury is not required to publish regulations taxing all conceivable fringe benefits not specifically covered in the legislation.

### DEFINITION OF EMPLOYEE

AGC believes the application of the fringe benefit provisions of H.R. 3525 is properly limited to common law employees. AGC is opposed to the proposal of the American Bar Association to expand coverage to self employed individuals. Self employed individuals are in fact "employers". Applying employee fringe benefit rules to self employed individuals is simply not appropriate.

### CAFETERIA PLANS

AGC's recommendation concerning cafeteria plans is to treat any changes to those plans in separate legislation. The principal provisions of H.R. 3525 apply to nonstatutory fringe benefits. As a statutory fringe benefit, inclusion of cafeteria plan rules will only detract from and confuse the intent of the legislation.

### DE MINIMIS BENEFITS

AGC supports excluding de minimis fringe benefits from income. Benefits with small values are provided to employees for a variety of business reasons. Including the value of such benefits in income is an unnecessary burden for employers. However, the requirement in H.R. 3525 that such benefits be aggregated undercuts the reason for not accounting for such benefits and we recommend that the aggregation rule be deleted from the bill.

As indicated above, AGC believes further study of the legislation is required. The impact of the legislation on current business practices and corresponding paper work requirements have not been adequately reviewed. Congress should extend the present moratorium on fringe benefit regulations until a full assessment of the legislation is made by both governmental authorities and taxpayers.

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MACHINERY & ALLIED PRODUCTS INSTITUTE,
*Washington, D.C., August 10, 1983.*

Hon. FORTNEY H. STARK,
*Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.*

DEAR MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

### THE PERMANENT TAX TREATMENT OF FRINGE BENEFITS ACT OF 1983: PUBLIC HEARINGS CONCERNING H.R. 3525

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to offer its views in public proceedings of the Subcommittee on Select Revenue Measures concerning the proposed H.R. 3525, "The Permanent Tax Treatment of Fringe Benefits Act of 1983," and we ask that our statement be entered in the record. The bill in question—to summarize—is aimed at assigning values to and imposing taxes on a number of nonstatutory fringe benefits that currently either are not treated as taxable income or are administered inconsistently because of differences of opinion about their tax attributes. A congressional "freeze" on efforts by the Department of the Treasury to resolve fringe benefit questions by regulation is scheduled to expire December 31, 1983, unless extended by Congress or superseded by new policy.

According to H.R. 3525, any fringe benefit which does not qualify for exclusion under the bill or under another specific statutory fringe benefit provision would be taxable to the recipient, under Internal Revenue Code Sections 61 and 83, at the excess of its fair market value over any amount paid by the employee for the benefit. The excluded fringe benefits would be those that qualify under one of four categories defined in the bill, as follows: (1) a no-additional-cost service; (2) a qualified employee discount; (3) a working condition fringe; or (4) a de minimis fringe. Special rules would apply with respect to parking provided to employees; demonstration cars used by automobile salespersons; employee use of employer-provided recreational facilities on the premises of an employer; and certain tuition reduction plans provided for school employees and their families. Some of the exclusions would apply only if the benefit were available to employees on a nondiscriminatory basis. The effective date would be January 1, 1984, except that the tuition reduction exclusion would apply for education furnished after June 30, 1984.

To set down our thoughts in brief, the sponsors of H.R. 3525 are to be commended for coming to grips with some difficult questions. Several organizations in and out of government have offered their views on the tax attributes of nonstatutory fringe benefits, but none have produced satisfactory solutions to our way of thinking. We suspect that the project before the subcommittee will be a lengthly one with progress measured in increments over a period of time rather than "quantum" changes of the sort anticipated by the bill. Indeed, we feel that "omnibus" legislation in this area of the type represented by H.R. 3525 is untimely, even if feasible in a longer time frame. Moreover, no attempt should be made to complete this moratorium on administrative initiatives expires at the end of 1983. With that in mind and in recognition that H.R. 3525 is a tax-increase measure being offered at a time when bills of this character are distasteful to a majority in Congress and to the Administration, we recommend a simple two-year extension of the "freeze" already in place.

As to the text of H.R. 3525, the bill is an admirable but unsuccessful effort to reconcile the notion that all income is taxable (unless specifically excused) with the fact that income is derived in some forms for which taxation is utterly impractical. More specifically, we offer the following, summarized observations:

1. The bill lacks balance, coming down forcefully on fringes of many employees who receive relatively little gain while allowing some vocal constituancies previously in opposition and having considerable compensation in kind to go comparatively harmless.
2. Parts of the bill lack equity, not only for the reason just mentioned, but also by disregarding employee payments on no-additional-cost fringes, by setting a profit percentage restriction on employee discounts, by using a trade or business requirement in connection with several exclusions, etc.
3. The bill would impose severe administrative burdens because of its introduction of the concepts of foregone revenue, the profit percentage limitation previously mentioned, the trade or business requirement also cited, valuation difficulties, and a host of other "do's" and "don'ts" that would determine the tax characteristics of the fringe benefit.
4. Portions of the bill are poorly defined or are defined without apparent foreknowledge of the full range of benefits covered (e.g., "working conditions"); the de minimis exclusion is not permitted to operate where other exclusions fail but minor amounts are involved; and the nondiscrimination test is stretched beyond the bounds of practicality.

The shortcomings of H.R. 3525 are manifold and systemic, leading us to conclude that this effort is unlikely to serve any worthwhile purpose under the pressure of a year-end deadline. Furthermore, there is nothing in our experience to suggest that nontaxed fringe benefits are being exploited to the detriment of the Treasury. Rather, in our opinion, the interest in this subject has been piqued by the desire of government to access more potential sources of revenue to support federal spending that seems to defy restraint. Stated another way, we do not consider noncompliance to be a significant issue here, although that is the "stalking horse" used by those who press the matter. Also, in our judgment, the law of diminishing returns (including escalating burden and inequity) stands in the way of taxation that would attempt to reach every imaginable form of personal enrichment.

Our objections to portions of H.R. 3525 constitute the remainder of this letter. We do not at this time have a comprehensive scheme of taxation to offer for nonstatutory fringe benefits.

*No-additional-cost service*

Under one fringe benefit exclusion, the entire value of any no-additional-cost service provided by an employer to or for the use of an employee (or to the emloyee's spouse or children) would be excluded for income and employment tax purposes, but only if the service were provided to employees on a nondiscriminatory basis (as defined).

To qualify under the exclusion, the service would have to be of the same type which is provided to the public in the ordinary course of the employer's trade or business in which the employee works, and the employer would have to incur no substantial additional cost in providing the service to the employee (or employee's family). For this purpose, the term "cost" would include any revenue foregone because the service had been made available to the employee or his family rather than to the general public. The determination of whether the employer had incurred any substantial additional cost in providing the benefit would be made without regard to any amounts paid to the employee for the service.

The exclusion would also be available where qualifying no-additional-cost service is provided by an employer to and for the use of an individual (or the individual's spouse or children) who formerly worked for the employer in the employer's trade or business in which the service is being provided and who separated from service with the employer in that trade or business because of retirement or disability.

*Comment.*—As far as it goes—which is not far enough—this exclusion seems unobjectionable to us. Unfortunately though, it is rather severely limited by the "specific trade or business" requirement. Also, although there would be some logic to including "foregone revenue" in determining whether "substantial additional cost" has been incurred, that aspect of the bill would depend to a greater extent than is necessary on subjective judgments and thereby be less easily administered on the part of taxpayers and IRS alike. Indeed, if foregone revenue is all that important, we do not know why it should be irrelevant that the employee has paid some amount in return for the service.

If the basic question is whether the "employer" has incurred substantial cost in providing the benefit to the employee, why should it matter that the service is generally provided to customers in the specific trade or business of the recipient's employer in which the employee is at the time providing services? If an employee works for one subsidiary of a company that constructs skyscrapers or manufactures aircraft carriers, why should he not be eligible to receive a no-additional-cost service from another subsidiary that operates a hotel chain, an airline, or a car rental agency as long as the parent company is agreeable and the "cost" test is met for the organization overall? Along the same lines, why should the tax status of benefits turn on corporate organization when it is known that this characteristic of a business changes for reasons having nothing to do with benefit programs and would disqualify recipients from exclusionary treatment under the bill? If absence of cost is the principal determinant, what is wrong with reciprocal arrangements, and what is the rationale for imputing income to persons who "hitchhike" on corporate transportation facilities?

Returning to "foregone revenue," we have no quarrel with the concept, but hasten to add that execution could be a morass. Standby travel by an airline employee happens to be a situation easily grasped, but services provided in other contexts could require complicated recordkeeping and subjective judgments, case-by-case. The subcommittee will quickly recognize that "foregone revenue" is a permutation of what is more familiarly referred to in business as "opportunity cost." We tend to doubt that IRS and taxpayers would ever agree on whether there was or was not a substantial opportunity cost associated with giving an employee an otherwise "free" service. The taxpayer would contend that he had incurred no cost; had no opportunity he cared to exploit; and, in fact, built goodwill and loyalty by providing the benefit. IRS would argue that the service in question obviously had a value and could have been sold to the public if the employer had only tried harder. We do not believe that the concept of foregone revenue is workable, and to disregard an employee's payment would be to reject an element of the "cost" test that should be taken into account.

In short, the idea of a "no-additional-cost" exclusion is fine, but the limitations on the exclusion proposed in H.R. 3525 are laced with inequity and impracticality.

### *Qualified employee discount*

Qualified discounts allowed to an employee (or to the employee's spouse or children) from the selling price of the employer's goods or services would be excluded up to 20 percent of the selling price, for income and employment tax purposes, but only if provided to employees on a nondiscriminatory basis.

To qualify under the exclusion, the goods or services on which the discount is available would have to be those which are offered for sale by the employer to customers in the ordinary course of the employer's trade or business in which the employee works. The exclusion would also be available where a qualified discount is provided by an employer to an individual (or to his spouse or children) if the individual had formerly worked for the employer in the employer's trade or business in which the service is being provided and separated from service with the employer in that trade or business because of retirement or disability.

The excludable amount of the discount would be limited to the lesser of (1) 20 percent of the price to which the goods or services are offered to non-employee customers by the employer, or (2) the employer's profit percentage (as defined).

*Comment.*—Here again, H.R. 3525 takes a relatively "clean" and understandable concept for an exclusion and stands it on its head. We already have commented on the "trade or business" limitation, and will not dwell at length on it here, other than to discuss it briefly in the discount merchandise (or service) context. Then we will mention the "profit percentage" test, which would be an administrative fiasco sufficient to ensure that many qualified employee discount programs would be discontinued rather than endure the burden.

Regarding the "trade or business" restriction, consider that many companies that manufacture and retail their own goods are organized with a parent holding company, manufacturing subsidiaries, finance subsidiaries, and retail subsidiaries. All of these companies are part of a single corporate family, have their own employees, and may be engaged in the production and sale of numerous product lines (however defined). Typically, all employees, including those of the parent company, manufacturing companies, and finance subsidiaries will be entitled to present identification in the retail stores enabling them to buy certain company products at a predetermined discount. There is nothing improper about this; no one is unduly enriched at government expense; the programs can be started, stopped, or changed as the company may deem appropriate for changing circumstances; the "store" is not being given away in a conspiracy to run up tax losses; and it is entirely reasonable that all employees are allowed to participate rather than just retail employees. As we read H.R. 3525, the "trade or business" limitation would foreclose these programs, and we suggest that it be eliminated.

The profit percentage limitation seems unworkable and unnecessary to us. It is unworkable because it would be enormously burdensome on a product-by-product basis to do the computations and provide the information to employees so that they could comply. Also, having part of the discount taxable and part tax-free would be confusing to employees; difficult for their personal accounting, recordkeeping, and tax return preparation, particularly where numerous purchases of different items are made at varying times in the course of the accounting period; and likely to involve very small amounts, in many instances incapable of justifying the costs of administration. In our opinion the profit percentage test is not improved by having it on an aggregate basis, except that the paperwork would be reduced where it shouldn't be imposed in the first place. One might ask what rationale supports the taxing of an employee's 20 percent discount in the case where the employer is operating a particular product line or the entire business at a loss and either wants to move "slow" inventory; wants to continue a fringe benefit program that pleases employees, regardless of temporary operating circumstances; wants to boost volume; is taking the loss on a product for promotional purposes; or is discontinuing a loser?

In our opinion, the connection, if any, between the tax losses of the employer and the existence of an employee discount program is very tenuous. Also, the proposal would put IRS in the business of setting product-line reporting regulations in one instance and uniform rules for determining aggregate profit percentages for trades or businesses in the other. Such a bureaucratic adventure would be out of the question, and we recommend that the profit percentage test be eliminated.

*Working condition fringe*

The fair market value of property or services provided primarily for the purpose of facilitating the employee's work for the employer would be excluded for income and employment tax purposes. This working condition exclusion would apply, however, only if substantially all (for this purpose, at least 85 percent) of the use of the property or services reasonably could be expected to occur in connection with the employee's performance of services, i.e., for business purposes. A benefit generally would be treated as a working condition fringe if it is provided by an employer primarily for the safety of its employees.

The fair market value of free or reduced cost parking would be excluded as a working condition fringe only if such parking were available on a nondiscriminatory basis (as defined).

The fair market value of the use of an employer-provided car by an automobile salesperson would be considered an excludable working condition fringe if (1) the car is provided primarily for the purpose of facilitating the employee's performance of service for the employer, (2) substantially all the use of the car by the salesperson occurs in the sales area in which the auto dealer's sales office is located, and (3) there are substantial restrictions on the personal use of the car by the salesperson.

*Comment.*—We have no grave difficulty with the idea of excluding a "working condition," whatever that phrase may embrace. However, we anticipate that defining "working condition" will be a challenge; that this particular exclusion may overlap others; and that company cars will—as usual—be the most troublesome item. In the case of a fringe provided for safety, the technical explanation of H.R. 3525 seems reasonable, but may have to be reconsidered as to limousines to include commuting where there are safety considerations that dictate such use. We take no exception in concept to the proposal with respect to parking, but note that it will work smoothly in some cases and not so well in others because of the nondiscrimination test and varying circumstances that will be encountered in practice. As to the demonstration cars of automobile salespersons, the general outline seems reasonable, but we caution against picky restrictions. Indeed, employer-provided vehicles for salespersons should be presumed to be excludable working condition fringes.

Salespersons aside, other employer-provided vehicles may prove to be a bone of contention. the personal use of a vehicle on a tax-free basis can be very valuable to an employee, and it is not clear to us how certain existing practices would fare under H.R. 3525. Indeed, we suspect that taxable income would result in some instances where employers have already passed IRS muster, and we question the need to reopen settled business. For example, employees putting significant personal milage on automobiles of their employers frequently have formal procedures for recognizing taxable income, but they are not uniform because the circumstances vary. How would these arrangements be affected, and why it is necessary to disturb them if that would be the case? If an automobile is used more than 15 percent for personal transportation, why eliminate the exclusion altogether when the more reasonable approach is to prorate the usage to ascertain the taxable amount? If corporate employees test and evaluate vehicles under normal conditions, including personal use, for their employers, how would the "working condition" exclusion apply to such personal use under H.R. 3525?

Inasmuch as the "working condition" exclusion is so amorphous, we urge caution in the effort to legislate.

*De minimis fringe*

If the fair market value of property or services which otherwise would be a taxable fringe benefit is so small that accounting for it would be unreasonable or administratively impractical, then the value would be excluded for income and employment tax purposes. In determining whether the de minimis exclusion applies, the values of all property or services provided to an employee during the year would be aggregated, except for (1) property or services that are excluded from taxation under a specific statutory exclusion provision (e.g., qualified employee discounts), and (2) any other property or service provided to the employee which had more than a "small" fair market value.

*Comment.*—We are in favor of a de minimis exclusion, but do not know how it would interact with other exclusions. In our view, the deminimis provision should embrace all the rest, so that a minor item in another category would be excluded in any event. H.R. 3525 does not so provide, and we recommend that it be reconsidered. Our other concern is the aggregation rule in another sense, because it could defeat the purpose of the exclusion. For example, many small services that are not easily administered for purposes of tax status determinations do not necessarily become manageable because they are repeated over and over. Our point is partially recognized in the technical explanation noting that "reduced cost cafeterias available to all employees" would fit this exclusion. Suppose, however, that many small services of different types were conferred on employees. Would the cafeteria example be controlling, or would aggregation be mandated? How would aggregation be performed? How, if at all, would the cafeteria example in the technical explanation of the bill relate to "executive dining rooms" operated for the convenience of the employer?

*Nondiscrimination rules*

To qualify under the bill for the no-additional-cost service exclusion, the qualified employee discount exclusion, the parking exclusion, or the qualified tuition reduction exclusion (not further discribed herein), the benefit would have to be available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer that does not discriminate in favor of officers, owners, or highly compensated employees. The determination of whether a particular classification is reasonable would depend on the facts and circumstances involved.

*Comment.*—These rules have an egalitarian ring that may satisfy someone's notion of equity, but they also would complicate the taxation of fringe benefits which, in turn, would lessen their use. Whether or not this is intended by the sponsors of H.R. 3525 is not clear, but the nondiscrimination rules could be disruptive of existing arrangements and may strike some observers as petty. Does the bill contemplate that fringe benefit plans will have to undergo IRS scrutiny in advance and obtain determination letters as to tax qualification? If the rent for an office includes two parking spaces, does one go to the president and the other to a clerk in order to avoid imputation of income? Must this be cleared with IRS in advance? If so, the nondiscrimination rules need much more study of their probable consequences before they are extended as proposed.

*Recreational facilities*

In general, the fair market value of any on-premise recreational facility provided and operated by an employer for its employees, where substantially all the use of the facility is by the employees (or their spouses or children), would be excluded for income and employment tax purposes. The recreational facility need not be in the same location as the business premises of the employer.

Further, the employer's deductions with respect to the on-site recreational facility would be limited in computing the employer's taxable income. No limitation would apply to any deduction (such as for interest or taxes) allowable to the employer without regard to the deduction's connection to a trade or business. In the case of other facility expenses, such as utilities, maintenance, depreciation, etc., the deductions could not exceed the amount of gross income from the property reduced by those deductions which are allowable regardless of their trade or business connection.

At the employer's election, the exclusion under the bill with respect to recreational facilities would not be available to its employees. In that case, the deduction limitation would not apply to the employer. The election would be made for any taxable year in a time and manner as prescribed in Treasury regulations. Any election made would apply to all recreational facilities of the employer. Once made, an election could not be revoked without permission of IRS.

*Comment.*—We are unaware of tax irregularities involving on-premise recreational facilities, and thus question the proposed limitation on employers' deductions. Also, the technical explanation does not reveal why the deduction limitation approach would be taken for this particular benefit.

### *Cafeteria plans*

The bill would amend the definition of cafeteria plans for purposes of Code Section 125 to provide that such plans may offer employees choices only among cash or those fringe benefits that are excludable from gross income under a specific section of the Internal Revenue Code (other than educational assistance, van pooling, and benefits excludable under provisions of H.R. 3525). Proponents of this change have contended that the mixture of taxable and nontaxable benefits in cafeteria plans "confuses" employees.

*Comment.*—We believe that cafeteria plans should not be changed by legislation at this time. Regulations are expected soon from IRS, and H.R. 3525 would simply create delay and confusion. As to the assertion that *employees* are confused already by the inclusion of taxable benefits in cafeteria plans, we are at a loss to know how this could occur when taxable amounts are reported on Forms W-2. Compared to the bewildering regulatory thicket that would stem from H.R. 3525, the charge of employee confusion about cafeteria plans seems rather out of place. Furthermore, we question the remark that these plans are designed to appeal to the highly compensated when it is common knowledge that tax avoidance is not the purpose of flexible compensation and that such plan must be nondiscriminatory as a matter of statutory mandate.

This concludes our thoughts at this time on H.R. 3525, and we trust that the Subcommittee will find them to be useful.

Respectfully,

CHARLES STEWART, *President.*

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MARIETTA COLLEGE,
CHARTERED 1835,
*Marietta, Ohio, July 20, 1983.*

Mr. JOHN SALMON,
*Chief Council, Committee on Ways and Means,*
*Longworth House Office Building, Washington, D.C.*

DEAR MR. SALMON: I want to register my views as the hearing approaches on whether or not to lift the moratorium against the taxation of tuition exchange, remission and scholarships. As the academic dean of a private liberal arts college I would like to testify that now is not the time to lift the moratorium. We need to continue to improve our educational system in America now more than ever. Because we have been able to offer tuition remission and a tuition exchange plan we have attracted better professors to our colleges. The logic that says we should replace these privileges with higher salaries is fallacious. The money is simply not available to pay the salaries that college professors deserve. We are not in the corporate world where high salaries are the norm.

In the search for more tax dollars there are many areas where they can be found. This is certainly not the time to have a financial punishment visited upon the colleges and universities of America. Some incentives have to be kept to attract bright teachers to institutions of higher education. I thank you for considering my views on this important issue.

Sincerely,

DWIGHT L. LING,
*Provost and Dean of the College.*

## STATEMENT OF THE NATIONAL ASSOCIATION OF INDEPENDENT SCHOOLS

The National Association of Independent Schools (NAIS) is a nonprofit voluntary organization serving 850 schools and 340,000 students throughout the United States. NAIS members include schools that are elementary and secondary, day and boarding, coeducational and single sex, traditional as well as experimental. The schools range in size from 36 to 3,600 students, and their founding dates go back to 1638. A list of the membership is attached.

Independent schools have been providing full or partial scholarships for children of faculty and other staff members for over fifty years. We believe tuition remission programs are a legitimate and traditional employer-provided benefit that in fact serve the national welfare as well as the recipient students. We endorse the comments and testimony presented to the Committee by the American Association of University Professors, American Council on Education, Association of American Universities, Association of Jesuit Colleges and Universities, and the National Association of Independent Colleges and Universities.

Certain characteristics of independent schools are important for a complete understanding of the role of tuition remission:

(1) Our schools tend to be small—enrollments average 300–400 students.

(2) Many independent schools operate in a precarious financial situation—last year over one-third of NAIS member schools operated in the red.

(3) Independent school faculty salaries are low—in the mid-Atlantic states, for example, the median salary for an experienced teacher in a coeducational day school is $15,500.

(4) Tuition in independent schools covers almost all of the cost of operation, and the amount of tuition would equal an overwhelming proportion of a faculty member's salary—in the same mid-Atlantic region mentioned above, where the median salary is $15,500, the median tuition is $3,800. Figures from other areas of the country are similar.

(5) Many independent schools have specialized curricula or admission standards that make admission impossible or unattractive to some faculty children—one fourth of our members limit enrollment to a single sex, and most have high academic requirements.

(6) Nongovernmental financial aid is a major means of encouraging access and diversity in independent schools—a total of approximately $90 million dollars was awarded to more than 38,000 students last year.

In summary, the National Association of Independent Schools endorses those provisions of H.R. 3525 that provide for a continuation of the current tax treatment of tuition remission programs. We would support any amendments providing similar protection for institutions with tuition exchange programs.

NATIONAL ASSOCIATION OF INDEPENDENT SCHOOLS
18 Tremont Street, Boston, Massachusetts 02108 (617) 723-6900

# GEOGRAPHIC LIST OF MEMBER SCHOOLS AND ASSOCIATIONS
## 1982-83

This document lists NAIS member schools geographically according to state and city, and regional associations of independent schools by title. The first 18 pages list schools located in the continental United States, Hawaii, and territories of the United States; pages 19-22 list schools located abroad; pages 23-27 list member associations.

Specific information on or applications for any particular schools should be obtained from the individual schools. Regional associations also provide information on their member schools.

Independent schools vary from one another in student type served (girls', boys', coeducational), in grade levels encompassed, and in whether the school is boarding or day. The symbols following the name of each school identify the school's characteristics:

### Key to Symbols

STU - student type
SCH - school type (boarding or day)
LG - earliest grade level at school
HG - highest grade level at school
B - boys'
G - girls'
C - coeducational
b - boarding (95% or more students)
b-d - boarding-day (50-94% boarding students)
d-b - day-boarding (50-94% day students)
d - day (95% or more students)
PS - preschool
K - kindergarten
PG - postgraduate
numerals 1-12 - grade levels

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GEOGRAPHIC LIST

| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| AL | Anniston | The Donoho School | C | d | 1 | 12 |
| AL | Birmingham | Highlands Day School | C | d | K | 6 |
| AL | Daphne | Bayside Academy | C | d | K | 12 |
| AL | Helena | Indian Springs School | C | db | 8 | 12 |
| AL | Huntsville | Randolph School | C | d | K | 12 |
| AL | Mobile | UMS Preparatory Sch | B | d | PS | 12 |
| AL | Mobile | The Julius T. Wright School | G | d | PS | 12 |
| AL | Mobile | St. Paul's Episcopal School | C | d | K | 12 |
| AL | Montgomery | The Montgomery Academy | C | d | K | 12 |
| AL | Tuscaloosa | Tuscaloosa Academy | C | d | K | 12 |
| AZ | Mayer | The Orme School | C | b | 9 | PG |
| AZ | Phoenix | All Saints Episcopal Day Sch. | C | d | K | 8 |
| AZ | Phoenix | Phoenix Country Day School | C | d | K | 12 |
| AZ | Scottsdale | Judson School | C | bd | 1 | PG |
| AZ | Sedona | Verde Valley School | C | b | 9 | PG |
| AZ | Tucson | The Fenster Sch of So. Arizona | C | bd | 7 | 12 |
| AZ | Tucson | Green Fields C. D. School | C | d | 5 | 12 |
| CA | Carlsbad | Army And Navy Academy | B | bd | 7 | 12 |
| CA | Carpinteria | The Cate School | C | bd | 9 | 12 |
| CA | Claremont | Foothill Country Day School | C | d | K | 8 |
| CA | Claremont | The Webb Schools | C | bd | 9 | 12 |
| CA | Corona del Mar | Harbor Day School | C | d | K | 8 |
| CA | Corte Madera | Marin Country Day School | C | d | K | 8 |
| CA | Culver City | Curtis School Foundation | C | d | K | 9 |
| CA | Danville | The Athenian School | C | bd | 7 | 12 |
| CA | Hillsborough | Crystal Springs & Uplands Schs | C | d | 6 | 12 |
| CA | Hillsborough | Nueva Learning Center | C | d | PS | 6 |
| CA | Idyllwild | The Desert Sun School | C | bd | 8 | 12 |
| CA | La Canada | Flintridge Preparatory School | C | d | 7 | 12 |
| CA | La Jolla | The Bishop's Schools | C | db | 7 | 12 |
| CA | La Jolla | La Jolla Country Day School | C | d | PS | PG |
| CA | Los Angeles | Brentwood School | C | d | 7 | 12 |
| CA | Los Angeles | Westlake School for Girls | G | d | 7 | 12 |
| CA | Los Angeles | Windward School | C | d | 7 | 12 |
| CA | Los Angeles | The John Thomas Dye School | C | d | PS | 6 |
| CA | Los Angeles | The Marlborough School | G | d | 7 | 12 |
| CA | Los Angeles | Marymount High School | G | d | 9 | 12 |
| CA | Los Angeles | Pilgrim School | C | d | K | 12 |
| CA | Los Gatos | Hillbrook School | C | d | PS | 8 |
| CA | Los Olivos | Dunn School | C | bd | 6 | 12 |
| CA | Los Olivos | Midland School | C | b | 9 | 12 |
| CA | Menlo Park | Menlo School | C | d | 7 | 12 |
| CA | Menlo Park | The Phillips Brooks School | C | d | PS | 6 |
| CA | Menlo Park | Sacred Heart Schools | G | db | PS | 12 |
| CA | Mill Valley | Mount Tamalpais Primary School | C | d | K | 8 |
| CA | Monterey | The York School | C | d | 8 | 12 |
| CA | Monterey | Santa Catalina School | G | db | PS | 12 |
| CA | North Hollywood | Campbell Hall | G | d | K | 12 |

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GEOGRAPHIC LIST

| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| CA | North Hollywood | Harvard School | B | d | 7 | 12 |
| CA | North Hollywood | Oakwood School | C | d | K | 12 |
| CA | Oakland | The College Preparatory School | C | d | 9 | 12 |
| CA | Oakland | The Head-Royce School | C | d | K | 12 |
| CA | Ojai | The Thacher School | C | bd | 9 | 12 |
| CA | Ojai | Happy Valley School | C | bd | 7 | 12 |
| CA | Ojai | Ojai Valley School | C | bd | 3 | 12 |
| CA | Pacific Palisades | St. Matthew's Parish School | C | d | PS | 8 |
| CA | Palm Springs | The Palm Valley School | C | d | K | 9 |
| CA | Palo Alto | Castilleja School | G | db | 7 | 12 |
| CA | Palos Verdes Pnsla | Chadwick School | C | d | K | 12 |
| CA | Pasadena | The Chandler School | C | d | K | 8 |
| CA | Pasadena | Westridge School | G | d | 4 | 12 |
| CA | Pasadena | Mayfield Senior School | G | d | 9 | 12 |
| CA | Pasadena | Polytechnic School | C | d | PS | 12 |
| CA | Pebble Beach | Robert Louis Stevenson School | C | db | 9 | 12 |
| CA | Ross | Katharine Branson School and | C | d | 9 | 12 |
| CA | Sacramento | Sacramento Country Day School | C | d | K | 12 |
| CA | San Anselmo | San Domenico School | G | db | PS | 12 |
| CA | San Diego | All Saints' Episcopal School | C | d | PS | 6 |
| CA | San Diego | Francis W. Parker School | C | d | PS | 12 |
| CA | San Diego | Univ. of San Diego High School | C | d | 9 | 12 |
| CA | San Francisco | Cathedral School for Boys | B | d | K | 8 |
| CA | San Francisco | Town School for Boys | B | d | K | 8 |
| CA | San Francisco | Urban School of San Francisco | C |  |  |  |
| CA | San Francisco | The Hamlin School | G | d | K | 8 |
| CA | San Francisco | Katherine Delmar Burke School | G | d | K | 8 |
| CA | San Francisco | Lick-Wilmerding High School | C | d | 9 | 12 |
| CA | San Francisco | San Francisco Univ.High School | C | d | 9 | 12 |
| CA | San Francisco | Schools of the Sacred Heart | G | d | PS | 12 |
| CA | San Gabriel | Clairbourn School | C | d | PS | 9 |
| CA | San Marino | Southwestern Academy | C | bd | 1 | 12 |
| CA | San Rafael | Marin Academy | C | d | 9 | 12 |
| CA | Santa Barbara | Laguna Blanca School | C | d | K | 12 |
| CA | Santa Monica | Crossroads St. Augustine Sch. | C | d | K | 12 |
| CA | Walnut Creek | The Seven Hills School | C | d | PS | 6 |
| CO | Aspen | Aspen Country Day School | C | db | K | PG |
| CO | Canon City | The Abbey School | B | bd | 9 | 12 |
| CO | Canon City | St. Scholastica Academy | G | bd | 8 | 12 |
| CO | Carbondale | The Colorado Rocky Mtn. School | C | bd | 10 | 12 |
| CO | Colorado Springs | The Colorado Springs School | C | db | K | 12 |
| CO | Colorado Springs | Fountain Valley School | C | bd | 9 | 12 |
| CO | Denver | Colorado Academy | C | d | K | 12 |
| CO | Denver | Graland Country Day School | C | d | PS | 9 |
| CO | Denver | St. Anne's Episcopal Sch. Inc. | C | d | PS | 8 |
| CO | Englewood | Kent Denver Country Day School | C | d | 7 | 12 |
| CO | Steamboat Springs | The Whiteman School | C | bd | 9 | 12 |
| CO | Vail | Vail Mountain School | C | d | 1 | 12 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| CT | Avon | Avon Old Farms School | B | bd | 9 | 12 |
| CT | Cheshire | The Cheshire Academy | C | bd | 5 | PG |
| CT | Cornwall | The Marvelwood School | C | bd | 9 | 12 |
| CT | Danbury | Wooster School | C | db | 7 | 12 |
| CT | East Haddam | Becket Academy | C | b | 7 | PG |
| CT | Fairfield | Fairfield College Prep School | B | d | 9 | 12 |
| CT | Fairfield | Fairfield Country Day School | B | d | K | 9 |
| CT | Fairfield | The Unquowa School | C | d | PS | 8 |
| CT | Farmington | Miss Porter's School | G | bd | 9 | 12 |
| CT | Green Farms | Greens Farms Academy | C | d | K | 12 |
| CT | Greenwich | Brunswick School | B | d | PS | 12 |
| CT | Greenwich | Convent of the Sacred Heart | G | db | K | 12 |
| CT | Greenwich | Daycroft School | C | bd | 7 | 12 |
| CT | Greenwich | Whitby School | C | d | PS | 9 |
| CT | Greenwich | Greenwich Academy | G | d | PS | 12 |
| CT | Greenwich | Greenwich Country Day School | C | d | PS | 9 |
| CT | Greenwich | Mead School for Human Develop. | C | d | PS | 8 |
| CT | Hartford | Watkinson School | C | d | 7 | 12 |
| CT | Kensington | Mooreland Hill School | C | d | 6 | 9 |
| CT | Kent | Kent School | C | b | 9 | 12 |
| CT | Lakeville | The Hotchkiss School | C | bd | 9 | PG |
| CT | Lakeville | Indian Mountain School | C | db | 5 | 9 |
| CT | Litchfield | The Forman Schools | C | b | 9 | 12 |
| CT | Madison | The Country School | C | d | PS | 8 |
| CT | Madison | The Hammonasset School | C | d | 8 | PG |
| CT | Middlebury | Westover School | G | bd | 9 | 12 |
| CT | Middlefield | The Independent Day School | C | d | K | 8 |
| CT | New Canaan | New Canaan Country School | C | d | K | 9 |
| CT | New Canaan | St. Luke's School | C | d | 6 | 12 |
| CT | New Haven | The Foote School | C | d | K | 9 |
| CT | New Haven | Hamden Hall Country Day School | C | d | PS | 12 |
| CT | New Haven | Hopkins Gr. Day Prospect Hill | C | d | 7 | 12 |
| CT | New London | The Williams School | C | d | 7 | 12 |
| CT | New Milford | Canterbury School | C | bd | 9 | PG |
| CT | Pomfret | Pomfret School | C | bd | 9 | 12 |
| CT | Pomfret | The Rectory School | C | bd | 6 | 9 |
| CT | Salisbury | Salisbury School | B | bd | 9 | 12 |
| CT | Simsbury | The Ethel Walker School | G | bd | 9 | PG |
| CT | Simsbury | Westminster School | C | bd | 9 | PG |
| CT | South Kent | South Kent School | C | b | 9 | 12 |
| CT | Stamford | King School | B | d | 1 | 12 |
| CT | Stamford | The Long Ridge School | C | d | PS | 8 |
| CT | Stamford | Low-Heywood Thomas School | G | d | 4 | 12 |
| CT | Stonington | Pine Point School | C | d | K | 9 |
| CT | Suffield | Suffield Academy | C | bd | 9 | PG |
| CT | Wallingford | Choate Rosemary Hall | C | bd | 9 | PG |
| CT | Washington | Wykeham Rise School | G | bd | 9 | 12 |
| CT | Washington | The Gunnery | C | bd | 9 | PG |

# N.A.I.S.

## GEOGRAPHIC LIST

| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| CT | Washington | Rumsey Hall School | C | bd | 2 | 9 |
| CT | Waterbury | Saint Margaret's McTernan Sch. | C | d | K | 12 |
| CT | Watertown | The Taft School | C | bd | 9 | PG |
| CT | West Hartford | Kingswood-Oxford School, Inc. | C | d | 7 | 12 |
| CT | West Hartford | Renbrook School | C | d | PS | 9 |
| CT | Westbrook | The Oxford Academy | B | b | 7 | PG |
| CT | Windsor | The Loomis Chaffee School | C | db | 9 | 12 |
| DC | Washington | Beauvoir | C | d | PS | 3 |
| DC | Washington | Capitol Hill Day School | C | d | PS | 8 |
| DC | Washington | Georgetown Day School | C | d | PS | 12 |
| DC | Washington | Georgetown Visitation Prep Sch | G | d | 9 | 12 |
| DC | Washington | Sheridan School | C | d | K | 8 |
| DC | Washington | The Maret School | C | d | K | 12 |
| DC | Washington | National Cathedral School | G | d | 4 | 12 |
| DC | Washington | National Presbyterian School | C | d | PS | 3 |
| DC | Washington | St. Albans School | B | db | 4 | 12 |
| DC | Washington | St. Anselm's Abbey School | B | d | 7 | 12 |
| DC | Washington | The Sidwell Friends School | C | d | PS | 12 |
| DE | Claymont | Archmere Academy | C | d | 9 | 12 |
| DE | Hockessin | Sanford School | C | d | PS | 12 |
| DE | Middletown | The Broadmeadow School | C | d | K | 12 |
| DE | Middletown | St. Andrew's School | C | b | 8 | 12 |
| DE | Wilmington | The Tatnall School | C | d | PS | 12 |
| DE | Wilmington | Tower Hill School | C | d | PS | 12 |
| DE | Wilmington | Wilmington Friends School | C | d | PS | 12 |
| DE | Wilmington | The Pilot School, Inc | C | d | 1 | 8 |
| FL | Boca Raton | Boca Raton Academy | C | d | 1 | 12 |
| FL | Boca Raton | Saint Andrew's School | C | db | 7 | 12 |
| FL | Bradenton | Saint Stephen's Episcopal Sch | C | d | K | 12 |
| FL | Clearwater | Saint Paul's School | C | d | K | 8 |
| FL | Ft Lauderdale | Pine Crest School | C | db | PS | 12 |
| FL | Ft. Lauderdale | University School of Nova Univ | C | d | PS | 12 |
| FL | Gulf Stream | Gulf Stream School | C | d | PS | 9 |
| FL | Jacksonville | Bartram School | G | db | 5 | 12 |
| FL | Jacksonville | The Bolles School | C | db | K | 12 |
| FL | Jacksonville | Jacksonville Country Day Sch. | C | d | PS | 9 |
| FL | Jacksonville | Jacksonville Episcopal H. S. | C | d | 7 | 12 |
| FL | Jacksonville | Oakwood Country Day School | C | d | PS | 6 |
| FL | Jacksonville | Riverside Presbyt. Day School | C | d | PS | 6 |
| FL | Miami | Miami Country Day School | C | d | K | 12 |
| FL | Miami | Ransom-Everglades School, Inc. | C | d | 7 | 12 |
| FL | North Palm Beach | The Benjamin School | C | d | 7 | 12 |
| FL | Orange Park | St. Johns Country Day School | C | d | 1 | 12 |
| FL | Orlando | Trinity Preparatory School | C | d | 7 | 12 |
| FL | Palm Beach | The Palm Beach Academy | C | d | 8 | 12 |
| FL | Palm Beach | Palm Beach Day School | C | d | PS | 9 |
| FL | Sarasota | The Out-Of-Door Academy | C | d | K | 12 |
| FL | St. Petersburg | Shorecrest Preparatory School | C | d | K | 12 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| FL | Stuart | Saint Michael's School | C | d | K | 8 |
| FL | Tallahasee | The Maclay School | C | d | K | 12 |
| FL | Tampa | Berkeley Preparatory School | C | d | K | 12 |
| FL | Tampa | Independent Day School | C | d | PS | 8 |
| FL | Tampa | St Mary's Episcopal Day School | C | d | K | 8 |
| FL | Tampa | Tampa Preparatory School | C | d | 9 | 12 |
| FL | Vero Beach | Saint Edward's School | C | d | K | 12 |
| GA | Athens | Athens Academy | C | d | PS | 12 |
| GA | Atlanta | Trinity School | C | d | PS | 6 |
| GA | Atlanta | The Westminster Schools | C | d | K | 12 |
| GA | Atlanta | Holy Innocents' Episcopal Sch. | C | d | PS | 8 |
| GA | Atlanta | The Lovett School | C | d | PS | 12 |
| GA | Atlanta | Marist School | C | d | 7 | 12 |
| GA | Atlanta | Pace Academy | C | d | K | 12 |
| GA | Augusta | Augusta Preparatory School | C | d | 7 | 12 |
| GA | College Park | Woodward Academy | C | db | PS | 12 |
| GA | Columbus | Brookstone School | C | d | PS | 12 |
| GA | Gainesville | Brenau Academy | G | bd | 9 | PG |
| GA | Keysville | Boggs Academy | C | b | 8 | 12 |
| GA | Marietta | Joseph T. Walker School | C | d | PS | 12 |
| GA | Mount Berry | Berry Academy | C | db | 5 | 12 |
| GA | Newnan | The Heritage School | C | d | K | 12 |
| GA | Rabun Gap | Rabun Gap-Nacoochee School | C | bd | 8 | 12 |
| GA | Rome | Darlington School | C | db | K | PG |
| GA | Savannah | St. Andrew's on the Marsh | C | d | K | 12 |
| GA | Savannah | The Savannah C. D. School | C | d | PS | 12 |
| GA | Thomasville | Brookwood School | C | d | K | 12 |
| GA | Waycross | Southwood School | C | d | K | 12 |
| HI | Honolulu | Academy of the Pacific | C | d | 7 | 12 |
| HI | Honolulu | Hanahauoli School | C | d | PS | 6 |
| HI | Honolulu | Hawaii School for Girls | G | d | 7 | 12 |
| HI | Honolulu | Iolani School | C | d | K | 12 |
| HI | Honolulu | Punahou School | C | d | K | 12 |
| HI | Honolulu | St. Andrew's Priory School | G | d | K | 12 |
| HI | Honolulu | The Kamehameha Schools | C | db | K | 12 |
| HI | Kailua | Le Jardin Academy | C | d | PS | 8 |
| HI | Kamuela | The Hawaii Preparatory Academy | C | db | K | 12 |
| HI | Maui | Seabury Hall | C | db | 7 | 12 |
| IA | Bettendorf | St. Katharine's-St. Mark's Sch | C | d | PS | 12 |
| ID | Ketchum | The Community School | C | d | 7 | 12 |
| IL | Chicago | Anshe Emet Day School | C | d | PS | 8 |
| IL | Chicago | Francis W. Parker School | C | d | PS | 12 |
| IL | Chicago | Univ. of Chicago Lab. Schools | C | d | PS | 12 |
| IL | Chicago | The Latin School of Chicago | C | d | PS | 12 |
| IL | Chicago | Morgan Park Academy | C | d | K | 12 |
| IL | Chicago | Sac. Ht. Schs. at Sheridan Rd. | G | d | 9 | 12 |
| IL | Downers Grove | Avery Coonley School | C | d | PS | 8 |
| IL | Elgin | Chicago Junior School | C | db | PS | 8 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| IL | Elgin | The Elgin Academy | C | db | 6 | 12 |
| IL | Evanston | Roycemore School | C | d | PS | 12 |
| IL | Lake Forest | Woodlands Academy/Sacred Heart | G | db | 9 | 12 |
| IL | Lake Forest | Lake Forest Academy-Ferry Hall | C | bd | 9 | 12 |
| IL | Lake Forest | Lake Forest Country Day School | C | d | PS | 9 |
| IL | Nauvoo | St. Mary's Academy | G | b | 9 | 12 |
| IL | Rockford | Keith Country Day School | C | d | PS | 12 |
| IL | Springfield | City Day School Of Springfield | C | d | K | 8 |
| IL | Winnetka | The North Shore C. D. School | C | d | PS | PG |
| IN | Culver | Culver Military & Girls Acad. | C | bd | 8 | 12 |
| IN | Evansville | Evansville Day School | C | d | PS | 12 |
| IN | Ferdinand | Marian Heights Academy | G | b | 9 | 12 |
| IN | Howe | Howe Military School | B | b | 5 | 12 |
| IN | Indianapolis | Park-Tudor School | C | d | PS | 12 |
| IN | La Porte | La Lumiere School | C | bd | 9 | 12 |
| IN | South Bend | The Stanley Clark School | C | d | K | 8 |
| KS | Wichita | Wichita Collegiate School | C | d | PS | 12 |
| KY | Covington | Villa Madonna Academy | G | d | 1 | 12 |
| KY | Frankfort | Capital Day School | C | d | PS | 8 |
| KY | Goshen | St. Francis School | C | d | K | 8 |
| KY | Hopkinsville | University Heights Academy | C | d | K | 12 |
| KY | Lexington | The Lexington School | C | d | PS | 9 |
| KY | Lexington | Sayre School | C | d | PS | 12 |
| KY | Louisville | Kentucky Country Day School | C | d | K | 12 |
| KY | Louisville | The Louisville Collegiate Sch. | G | d | K | 12 |
| LA | Baton Rouge | Episcopal High School | C | d | 5 | 12 |
| LA | Metairie | Metairie Park C. D. School | C | d | K | 12 |
| LA | Metairie | St. Martin's Prot. Epis. Sch. | C | d | PS | 12 |
| LA | New Orleans | Trinity Episcopal School | C | d | PS | 8 |
| LA | New Orleans | Isidore Newman School | C | d | K | 12 |
| LA | New Orleans | Louise S. McGehee School | G | d | PS | 12 |
| LA | Shreveport | First Baptist Church School | C | d | PS | 12 |
| LA | Shreveport | Southfield School | C | d | PS | 12 |
| MA | Amherst | The Common School | C | d | PS | 6 |
| MA | Andover | Phillips Academy | C | bd | 9 | 12 |
| MA | Andover | The Pike School | C | d | PS | 9 |
| MA | Ashburnham | Cushing Academy | C | bd | 9 | PG |
| MA | Belmont | The Arlington School | C | bd | 9 | 12 |
| MA | Belmont | Belmont Day School | C | d | PS | 6 |
| MA | Belmont | Belmont Hill School | B | db | 7 | 12 |
| MA | Beverly | Shore Country Day School | C | d | K | 9 |
| MA | Boston | Commonwealth School | C | d | 9 | 12 |
| MA | Boston | The Winsor School | G | d | 5 | 12 |
| MA | Boston | Newman Preparatory School | C | d | 9 | PG |
| MA | Braintree | Thayer Academy | C | d | 6 | 12 |
| MA | Brookline | Dexter School | B | d | 1 | 8 |
| MA | Brookline | The Park School | C | d | PS | 9 |
| MA | Byfield | Governor Dummer Academy | C | bd | 9 | 12 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| MA | Brookline | The Park School | C | d | PS | 9 |
| MA | Byfield | Governor Dummer Academy | C | bd | 9 | 12 |
| MA | Cambridge | Buckingham Browne & Nichols | C | d | K | 12 |
| MA | Cambridge | Cambridge Friends School | C | d | K | 8 |
| MA | Cambridge | Manter Hall School | C | d | 9 | 12 |
| MA | Cambridge | Shady Hill School | C | d | PS | 9 |
| MA | Chestnut Hill | The Beaver Country Day School | C | d | 5 | 12 |
| MA | Chestnut Hill | Brimmer & May School | G | d | PS | 12 |
| MA | Chestnut Hill | The Chestnut Hill School | C | d | PS | 6 |
| MA | Concord | Concord Academy | C | db | 9 | 12 |
| MA | Concord | The Fenn School | B | d | 4 | 9 |
| MA | Concord | Middlesex School | C | bd | 9 | 12 |
| MA | Concord | Nashoba Brooks Sch of Concord | G | d | PS | 8 |
| MA | Dedham | Dedham Country Day School | C | d | PS | 8 |
| MA | Dedham | Noble and Greenough School | C | db | 7 | 12 |
| MA | Deerfield | The Bement School | C | db | K | 9 |
| MA | Deerfield | Deerfield Academy | B | bd | 9 | PG |
| MA | Deerfield | Eaglebrook School | B | bd | 5 | 9 |
| MA | Dover | Charles River School | C | d | PS | 8 |
| MA | East Northfield | Northfield Mount Hermon School | C | bd | 9 | PG |
| MA | Easthampton | The Williston Northampton Sch. | C | bd | 7 | 12 |
| MA | Fitchburg | Applewild School | C | d | PS | 9 |
| MA | Great Barrington | Simon's Rock of Bard College | C | b | 11 | PG |
| MA | Greenfield | Stoneleigh-Burnham School | G | bd | 9 | 12 |
| MA | Groton | The Lawrence Academy At Groton | C | bd | 9 | 12 |
| MA | Groton | Groton School | C | bd | 8 | 12 |
| MA | Hingham | Derby Academy | C | d | PS | 9 |
| MA | Lenox | Berkshire Country Day School | C | d | PS | 9 |
| MA | Lexington | Lexington Christian Academy | C | d | 7 | 12 |
| MA | Lincoln | The Carroll School | C | d | 1 | 10 |
| MA | Manchester | Brookwood School | C | d | K | 8 |
| MA | Marblehead | Tower School | C | d | PS | 9 |
| MA | Marion | Tabor Academy | C | bd | 9 | 12 |
| MA | Marlborough | Hillside School | B | b | 3 | 8 |
| MA | Milton | Milton Academy | C | db | K | 12 |
| MA | Natick | The Walnut Hill School | G | bd | 7 | 12 |
| MA | Needham | St. Sebastian's C. D. School | B | d | 7 | 12 |
| MA | Newton | Newton C. D. Sch/Sacred Heart | G | d | 7 | 12 |
| MA | North Andover | Brooks School | C | bd | 9 | 12 |
| MA | North Dartmouth | Friends Academy | C | d | K | 9 |
| MA | Northampton | Smith College Campus School | C | d | PS | 5 |
| MA | Pittsfield | Miss Hall's School | G | bd | 9 | 12 |
| MA | Sheffield | Berkshire School | C | bd | 9 | PG |
| MA | South Hamilton | The Pingree School | C | d | 9 | 12 |
| MA | Southborough | Fay School | C | db | 1 | 9 |
| MA | Southborough | Saint Mark's of Southborough | C | bd | 9 | 12 |
| MA | Springfield | The MacDuffie School | G | db | 7 | 12 |
| MA | W Roxbury | The Roxbury Latin School | B | d | 7 | 12 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| MA | Waltham | Chapel Hill-Chauncy Hall Sch. | C | bd | 9 | PG |
| MA | Watertown | Palfrey Street School | C | d | 9 | 12 |
| MA | Wellesley | Dana Hall School | G | bd | 7 | PG |
| MA | Wellesley Mass | Tenacre Country Day School | C | d | PS | 6 |
| MA | West Newton | The Fessenden School | B | db | 1 | 9 |
| MA | Weston | The Cambridge School | C | db | 9 | 12 |
| MA | Weston | The Meadowbrook School | C | d | PS | 6 |
| MA | Weston | The Rivers School | B | d | 7 | 12 |
| MA | Wilbraham | Wilbraham and Monson Academy | C | bd | 7 | PG |
| MA | Williamstown | The Pine Cobble School, Inc. | C | d | PS | 9 |
| MA | Winchendon | The Winchendon School | C | b | 9 | PG |
| MA | Worcester | The Bancroft School | C | d | K | 12 |
| MA | Worcester | Notre Dame Academy | G | d | 9 | 12 |
| MA | Worcester | Worcester Academy | C | db | 7 | PG |
| MD | Annapolis | The Key School | C | d | PS | 12 |
| MD | Baltimore | Boys Latin School | B | d | K | 12 |
| MD | Baltimore | The Bryn Mawr School | G | d | PS | 12 |
| MD | Baltimore | Calvert School | C | d | PS | 6 |
| MD | Baltimore | Friends School | C | d | PS | 12 |
| MD | Baltimore | Gilman School | B | d | 1 | 12 |
| MD | Baltimore | Roland Park Country School | G | d | PS | 12 |
| MD | Baltimore | Ruxton Country School | C | d | K | 6 |
| MD | Berlin | Worcester Country School | C | d | K | 12 |
| MD | Bethesda | The Holton Arms School | G | d | 3 | 12 |
| MD | Bethesda | Landon School | B | d | 3 | 12 |
| MD | Bethesda | Mater Dei School | B | d | 1 | 8 |
| MD | Bethesda | The Norwood School | C | d | K | 6 |
| MD | Bethesda | Stone Ridge-C. D. S. of S. H. | G | d | PS | 12 |
| MD | Brooklandville | The Park School | C | d | PS | 12 |
| MD | Brooklandville | Saint Paul's School | B | d | K | 12 |
| MD | Brooklandville | St. Paul's School for Girls | G | d | 5 | 12 |
| MD | Centreville | The Gunston School, Inc. | G | bd | 9 | 12 |
| MD | Chestertown | Kent School, Inc. | C | d | K | 8 |
| MD | Colora | West Nottingham Academy | C | bd | 9 | PG |
| MD | Easton | The Country School, Inc. | C | d | K | 8 |
| MD | Garrison | The Garrison Forest School | G | db | PS | 12 |
| MD | Gibson Island | The Gibson Island Ctry School | C | d | K | 6 |
| MD | Glencoe | Oldfields School | G | bd | 8 | 12 |
| MD | Glenelg | Glenelg Country School | C | d | K | 8 |
| MD | Huntingtown | The Calverton School | C | d | K | 12 |
| MD | Kensington | The Town & Country Day School | C | d | PS | 9 |
| MD | McDonogh | McDonogh School | C | db | K | 12 |
| MD | North East | The Tome School | C | d | K | 12 |
| MD | Olney | St. John's Parish School | C | d | K | 8 |
| MD | Potomac | The Bullis School | C | d | 5 | PG |
| MD | Potomac | Connelly Sch of the Holy Child | G | d | 9 | 12 |
| MD | Rockville | Georgetown Preparatory School | B | db | 9 | 12 |
| MD | Rockville | Green Acres School | C | d | PS | 8 |

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|---|---|---|---|---|---|---|
| MD | Saint James | Saint James School | C | bd | 8 | 12 |
| MD | Salisbury | Salisbury School | C | d | PS | 8 |
| MD | Severna Park | Severn School | C | d | 6 | 12 |
| MD | Stevenson | St. Timothy's School | G | bd | 9 | 12 |
| MD | Upper Marlboro | Queen Anne School | C | d | 7 | 12 |
| ME | Bath | Hyde School | C | bd | 7 | PG |
| ME | Bethel | Gould Academy | C | bd | 9 | PG |
| ME | Fryeburg | Fryeburg Academy | C | db | 8 | PG |
| ME | Hebron | Hebron Academy | C | bd | 9 | PG |
| ME | Kents Hill | Kents Hill School | C | bd | 9 | PG |
| ME | North Bridgton | Bridgton Academy | B | b | 12 | PG |
| ME | Portland | Waynflete School | C | d | PS | 12 |
| ME | South Berwick | Berwick Academy | C | d | 1 | 12 |
| ME | Vassalboro | Oak Grove-Coburn School | C | db | 6 | 12 |
| ME | Yarmouth | North Yarmouth Academy | C | d | 7 | 12 |
| MI | Ann Arbor | Greenhills School | C | d | 7 | 12 |
| MI | Birmingham | Detroit Country Day School | C | d | PS | 12 |
| MI | Bloomfield Hills | Academy of the Sacred Heart | G | d | PS | 12 |
| MI | Bloomfield Hills | The Cranbrook Schools | C | db | PS | 12 |
| MI | Bloomfield Hills | Kensington Academy | B | d | 1 | 8 |
| MI | Bloomfield Hills | Roeper City & Country Sch Inc | C | d | PS | 12 |
| MI | Detroit | Friends School in Detroit | C | d | PS | 12 |
| MI | Flint | The Valley School | C | d | PS | 12 |
| MI | Glen Arbor | The Leelanau School | C | bd | 9 | 12 |
| MI | Grosse Pointe Farms | The Grosse Pointe Academy | C | d | PS | 8 |
| MI | Grosse Pointe Woods | University Liggett School | C | d | PS | 12 |
| MI | Interlochen | Interlochen Arts Academy | C | b | 9 | PG |
| MI | Oxford | Kingsbury School | C | d | PS | 8 |
| MN | Collegeville | Saint Johns Preparatory School | C | bd | 9 | 12 |
| MN | Faribault | Shattuck - Saint Mary's | C | bd | 7 | PG |
| MN | Faribault | Wilson Center School | C | b | 8 | PG |
| MN | Minneapolis | The Blake Schools | C | d | K | 12 |
| MN | Minneapolis | Breck School | C | d | PS | 12 |
| MN | Saint Paul | St Paul Academy & Summit Sch | C | d | K | 12 |
| MN | St. Paul | Convent of the Visitation Sch | G | d | PS | 12 |
| MO | Creve Coeur | Rohan Woods School | C | d | PS | 6 |
| MO | Kansas City | The Barstow School | C | d | PS | 12 |
| MO | Kansas City | Pembroke-Country Day School | B | d | K | 12 |
| MO | Kansas City | The Sunset Hill School | G | d | PS | 12 |
| MO | Mexico | Missouri Military Academy | B | b | 4 | 12 |
| MO | Saint Louis | Mary Institute | G | d | K | 12 |
| MO | Saint Louis | Rossman School | C | d | PS | 6 |
| MO | Saint Louis | Saint Louis Country Day School | B | d | 5 | 12 |
| MO | Saint Louis | Thomas Jefferson School | C | bd | 8 | 12 |
| MO | Saint Louis | Whitfield School | C | d | 7 | 12 |
| MO | St Louis | The Forsyth School | C | d | PS | 6 |
| MO | St Louis | John Burroughs School | C | d | 7 | 12 |
| MO | St Louis | The Principia | C | db | PS | 12 |

| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| MO | St. Louis | Community School | C | d | PS | 6 |
| MO | St. Louis | Saint Louis Priory School | B | d | 7 | 12 |
| MS | Jackson | St. Andrew's Episcopal School | C | d | K | 12 |
| MS | Vicksburg | All Saints Episcopal School | C | bd | 8 | 12 |
| NC | Arden | Christ School | B | b | 8 | 12 |
| NC | Asheville | Asheville Country Day School | C | d | PS | 12 |
| NC | Asheville | Asheville School | C | bd | 9 | 12 |
| NC | Asheville | St. Genevieve/Gibbons Hall Sch | C | d | PS | 9 |
| NC | Charlotte | Charlotte Country Day School | C | d | K | 12 |
| NC | Charlotte | Charlotte Latin School | C | d | K | 12 |
| NC | Charlotte | Providence Day School | C | d | K | 12 |
| NC | Durham | Durham Academy | C | d | PS | 12 |
| NC | Glade Valley | Glade Valley School, Inc. | C | b | 9 | 12 |
| NC | Greensboro, | Greensboro Day School | C | d | K | 12 |
| NC | Lenoir | The Patterson School | C | bd | 7 | 12 |
| NC | Lewisville | Forsyth Country Day School | C | d | K | 12 |
| NC | Oak Ridge | Oak Ridge Military Academy | C | bd | 7 | 12 |
| NC | Raleigh | Ravenscroft School | C | d | PS | 12 |
| NC | Raleigh | St. Mary's College | G | bd | 11 | 12 |
| NC | Rocky Mount | Rocky Mount Academy | C | d | K | 12 |
| NC | Southern Pines | Wallace O'Neal Day School | C | d | K | 12 |
| NC | Wilmington | Cape Fear Academy | C | d | K | 12 |
| NC | Winston-Salem | Salem Academy | G | bd | 9 | 12 |
| NC | Winston-Salem | The Summit School | C | d | PS | 9 |
| NE | Omaha | Brownell-Talbot School | C | d | PS | 12 |
| NH | Andover | Proctor Academy | C | bd | 9 | PG |
| NH | Canaan | Cardigan Mountain School | B | b | 6 | 9 |
| NH | Canterbury | Horizon's Edge School | C | db | K | 6 |
| NH | Concord | St. Paul's School | C | b | 9 | 12 |
| NH | Dublin | Dublin School | C | bd | 9 | 12 |
| NH | Exeter | Phillips Exeter Academy | C | bd | 9 | 12 |
| NH | Littleton | The White Mountain School | C | bd | 9 | 12 |
| NH | Manchester | The Derryfield School | C | d | 7 | 12 |
| NH | Meriden | Kimball Union Academy | C | bd | 9 | PG |
| NH | New Hampton | The New Hampton School | C | bd | 9 | 12 |
| NH | Plymouth | Holderness School | C | bd | 9 | 12 |
| NH | Tilton | Tilton School | C | bd | 9 | PG |
| NH | Wilton | High Mowing School | C | bd | 8 | 12 |
| NH | Wolfeboro | Brewster Academy | C | bd | 9 | PG |
| NJ | Bernardsville | Gill/St Bernard's School | C | d | K | 12 |
| NJ | Blairstown | Blair Academy | C | bd | 9 | PG |
| NJ | Bridgeton | Woodland Country Day School | C | d | PS | 8 |
| NJ | Burlington | St. Mary's Hall-Doane Academy | C | d | K | 12 |
| NJ | Elizabeth | The Pingry School | C | d | K | 12 |
| NJ | Englewood | Dwight-Englewood School | C | d | 7 | 12 |
| NJ | Englewood | The Elisabeth Morrow School | C | d | PS | 6 |
| NJ | Far Hills | Far Hills Country Day School | C | d | PS | 9 |
| NJ | Hightstown | The Peddie School | C | bd | 8 | PG |

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|---|---|---|---|---|---|---|
| NJ | Lawrenceville | The Lawrenceville School | B | bd | 8 | 12 |
| NJ | Livingston | Newark Academy | C | d | 7 | 12 |
| NJ | Mendham | St. John Baptist School | G | bd | 7 | 12 |
| NJ | Montclair | The Montclair Kimberley Acad. | C | d | K | 12 |
| NJ | Moorestown | Moorestown Friends School | C | d | K | 12 |
| NJ | Morristown | Delbarton School | B | d | 7 | 12 |
| NJ | Morristown | The Morristown-Beard School | C | d | 7 | 12 |
| NJ | Morristown | The Peck School | C | d | K | 8 |
| NJ | Mountain Lakes | The Wilson School | G | d | K | 12 |
| NJ | Mountainside | The Vail-Deane School | C | d | K | 12 |
| NJ | Pennington | The Pennington School | C | db | 7 | 12 |
| NJ | Pine Beach | Admiral Farragut Academy | B | bd | 5 | PG |
| NJ | Plainfield | The Wardlaw-Hartridge School | C | d | K | 12 |
| NJ | Pottersville | The Purnell School | G | b | 10 | 12 |
| NJ | Princeton | The American Boychoir School | B | bd | 3 | 8 |
| NJ | Princeton | Chapin School | C | d | K | 8 |
| NJ | Princeton | The Hun School Of Princeton | C | db | 6 | PG |
| NJ | Princeton | Princeton Day School | C | d | K | 12 |
| NJ | Princeton | Stuart Country Day School | G | d | PS | 12 |
| NJ | Rumson | The Rumson Country Day School | C | d | K | 9 |
| NJ | Saddle River | Saddle River Day School | C | d | 5 | 12 |
| NJ | Short Hills | Far Brook School | C | d | PS | 9 |
| NJ | Somerset | Rutgers Preparatory School | C | d | K | 12 |
| NJ | Summit | Kent Place School | G | d | PS | 12 |
| NJ | Summit | Oak Knoll School of the | G | d | K | 12 |
| NM | Albuquerque | Albuquerque Academy | C | d | 6 | 12 |
| NM | Albuquerque | Menaul School | C | db | 9 | 12 |
| NM | Albuquerque | Sandia Preparatory School | C | d | 5 | 12 |
| NM | Santa Fe | Santa Fe Preparatory School | C | d | 7 | 12 |
| NY | Albany | Albany Academy | B | d | PS | 12 |
| NY | Albany | Albany Academy For Girls | G | d | PS | 12 |
| NY | Albany | The Doane Stuart School | C | db | PS | PG |
| NY | Bedford | Rippowam-Cisqua School | C | d | PS | 9 |
| NY | Brentwood | Academy of St. Joseph | G | d | K | 12 |
| NY | Bronx | Horace Mann-Barnard School | C | d | PS | 12 |
| NY | Brooklyn | Adelphi Academy | C | d | K | 12 |
| NY | Brooklyn | The Berkeley-Carroll Str. Sch. | C | d | PS | 12 |
| NY | Brooklyn | Brooklyn Friends School | C | d | K | 12 |
| NY | Brooklyn | The Packer Collegiate Inst. | C | d | K | 12 |
| NY | Brooklyn | Polytechnic Prep Ctry Day Sch. | C | d | 5 | 12 |
| NY | Brooklyn Heights | Saint Ann's School | C | d | 1 | 12 |
| NY | Buffalo | The Buffalo Seminary | G | d | 9 | 12 |
| NY | Buffalo | The Elmwood Franklin School | C | d | PS | 8 |
| NY | Buffalo | The Nichols School | C | d | 5 | 12 |
| NY | Congers | The Rockland C. D. School | C | d | 5 | 12 |
| NY | Cornwall-on-Hudson | New York Military Academy | C | bd |  |  |
| NY | Cornwall-on-Hudson | The Storm King School | C | bd | 9 | 12 |
| NY | Dewitt | Manlius-Pebble Hill School | C | d | K | 12 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| NY | Dobbs Ferry | The Masters School | G | bd | 7 | 12 |
| NY | Forest Hills | The Kew-Forest School | C | d | 1 | 12 |
| NY | Garden City | The Cathedral Sch. of St. Mary | G | d | 4 | 12 |
| NY | Garden City | St. Paul's School | B | db | 5 | 12 |
| NY | Garden City | The Waldorf School/Garden City | C | d | PS | 12 |
| NY | Garrison-on-Hudson | The Malcolm Gordon School | B | bd | 5 | 8 |
| NY | Glen Head, | The Green Vale School | C | d | PS | 9 |
| NY | Hewlett | Lawrence Country Day School | C | d | PS | 9 |
| NY | Hoosick | Hoosac School | C | bd | 8 | PG |
| NY | Jackson Heights | Garden School | C | d | K | 12 |
| NY | Katonah | The Harvey School | C | db | 4 | 12 |
| NY | Lake Placid Club | Northwood School | C | bd | 9 | PG |
| NY | Lake Placid, | North Country School | C | bd | 4 | 8 |
| NY | Locust Valley | Friends Academy | C | d | PS | PG |
| NY | Locust Valley | Portledge School | C | d | PS | 12 |
| NY | Loudonville | Saint Gregory's School | B | d | PS | 8 |
| NY | Millbrook | The Dutchess Day School | C | d | K | 8 |
| NY | Millbrook | Millbrook School | C | bd | 9 | 12 |
| NY | New Lebanon | Darrow School | C | b | 9 | 12 |
| NY | New York | Allen-Stevenson School | B | d | 1 | 9 |
| NY | New York | The Baldwin League of Ind. Sch | C | d | K | 12 |
| NY | New York | The Barnard School | C | d | K | 12 |
| NY | New York | Birch Wathen School | C | d | K | 12 |
| NY | New York | The Brearley School | G | d | K | 12 |
| NY | New York | The Browning School | B | d | K | 12 |
| NY | New York | The Buckley School | B | d | K | 9 |
| NY | New York | The Calhoun School | C | d | PS | 12 |
| NY | New York | The Cathedral School | C | d | K | 8 |
| NY | New York | The Chapin School | G | d | K | 12 |
| NY | New York | The Churchill School | C | d | PS | 6 |
| NY | New York | Collegiate School | B | d | 1 | 12 |
| NY | New York | Columbia Grammar & Prep Sch | C | d | K | 12 |
| NY | New York | Convent of the Sacred Heart | G | d | PS | 12 |
| NY | New York | Corleare School | C | d | PS | 6 |
| NY | New York | The Dalton School | C | d | PS | 12 |
| NY | New York | The Day School | C | d | PS | 8 |
| NY | New York | The Episcopal Sch/City of N.Y. | C | d | PS | K |
| NY | New York | The Ethical Culture Schools | C | d | PS | 12 |
| NY | New York | The Fleming School | C | d | PS | 8 |
| NY | New York | Friends Seminary | C | d | PS | 12 |
| NY | New York | Grace Church School | C | d | PS | 8 |
| NY | New York | The Hewitt School | G | d | K | 12 |
| NY | New York | The Lenox School | C | d | K | 12 |
| NY | New York | Little Red School House, Inc. | C | d | PS | 12 |
| NY | New York | The Loyola School | C | d | 9 | 12 |
| NY | New York | The McBurney School | C | d | 7 | 12 |
| NY | New York | Marymount School | G | d | PS | 12 |
| NY | New York | The New Lincoln School | C | d | K | 12 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| NY | New York | The Nightingale-Bamford School | G | d | K | 12 |
| NY | New York | Professional Childrens School | C | d | 4 | 12 |
| NY | New York | Regis High School | B | d | 9 | 12 |
| NY | New York | Rhodes School | C | d | 6 | 12 |
| NY | New York | The Riverdale Country School | C | d | PS | 12 |
| NY | New York | Robert Louis Stevenson School | C | d | 7 | 12 |
| NY | New York | Rudolf Steiner School | C | d | K | 12 |
| NY | New York | St. Bernard's School | B | d | 1 | 9 |
| NY | New York | Saint David's School | B | d | PS | 8 |
| NY | New York | St. Hilda's & St. Hugh's Sch. | C | d | PS | 12 |
| NY | New York | St. Luke's School | C | d | PS | 8 |
| NY | New York | St. Thomas Choir School | B | b | 5 | 8 |
| NY | New York | The Spence School | G | d | K | 12 |
| NY | New York | The Town School | C | d | PS | 8 |
| NY | New York | Trinity School | C | d | K | 12 |
| NY | New York | Walden School | C | d | PS | 12 |
| NY | Old Westbury | School Of The Holy Child | G | d | PS | 12 |
| NY | Oyster Bay | East Woods School | C | d | PS | 9 |
| NY | Pawling | Trinity-Pawling School | C | bd | 9 | 12 |
| NY | Poughkeepsie | Oakwood School | C | bd | 9 | 12 |
| NY | Poughkeepsie | Poughkeepsie Day School | C | d | PS | 12 |
| NY | Rochester | The Allendale Columbia School | C | d | PS | 12 |
| NY | Rochester | The Harley School | C | d | PS | 12 |
| NY | Roslyn | Buckley Country Day School | C | d | PS | 8 |
| NY | Rye | Rye Country Day School | C | d | PS | 12 |
| NY | Saint James | The Knox School | C | bd | 7 | 12 |
| NY | Saint James | Harbor Country Day School | C | d | K | 9 |
| NY | Snyder | The Park School of Buffalo | C | d | PS | 12 |
| NY | South Wales | The Gow School | B | b | 7 | 12 |
| NY | Staten Island | Staten Island Academy | C | d | PS | 12 |
| NY | Stony Brook | The Stony Brook School | C | db | 7 | 12 |
| NY | Tarrytown | Hackley School | C | d | K | 12 |
| NY | Troy | Emma Willard School | G | bd | 9 | PG |
| NY | Tuxedo Park | Tuxedo Park School | C | d | PS | 9 |
| NY | White Plains | Windward School | C | d | 1 | 10 |
| NY | Woodmere | Woodmere Academy | C | d | K | 12 |
| NY | Yonkers | The Halsted School | C | d | K | 12 |
| OH | Austinburg | The Grand River Academy | B | bd | 7 | 12 |
| OH | Barnesville | Olney Friends School | C | b | 9 | 12 |
| OH | Bath | Old Trail School | C | d | K | 8 |
| OH | Canton | Canton Country Day School | C | d | K | 8 |
| OH | Chagrin Falls | University School | B | d | K | 12 |
| OH | Cincinnati | Cincinnati Country Day School | C | d | PS | 12 |
| OH | Cincinnati | The Seven Hills Schools | C | d | PS | 12 |
| OH | Cleveland | Hathaway Brown School | G | d | PS | 12 |
| OH | Cleveland | Laurel School | G | d | PS | 12 |
| OH | Columbus | Columbus School for Girls | G | d | PS | 12 |
| OH | Dayton | The Miami Valley School | C | d | PS | 12 |

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## GEOGRAPHIC LIST

| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| OH | Gahanna | The Columbus Academy | B | d | K | 12 |
| OH | Gates Mills | Gilmour Academy | C | db | 7 | 12 |
| OH | Gates Mills | Hawken School | C | d | K | 12 |
| OH | Hudson | Western Reserve Academy | C | bd | 9 | 12 |
| OH | North Ridgeville | Lake Ridge Academy | C | d | K | 12 |
| OH | Toledo | Maumee Valley Country Day Sch. | C | d | PS | 12 |
| OH | Willoughby | The Andrews School | G | db | 7 | 12 |
| OK | Oklahoma City | Casady School | C | d | PS | 12 |
| OK | Oklahoma City | Heritage Hall | C | d | PS | 12 |
| OK | Oklahoma City | Westminster Day School | C | d | PS | 8 |
| OK | Tulsa | Holland Hall School | C | d | PS | 12 |
| OR | Neskowin | Neskowin Valley School | C | d | PS | 6 |
| OR | Portland | The Catlin Gabel School | C | d | PS | 12 |
| OR | Portland | Oregon Episcopal School | C | db | PS | 12 |
| PA | Allentown | The Swain School | C | d | PS | 12 |
| PA | Bethlehem | Moravian Academy | C | db | PS | PG |
| PA | Bryn Mawr | The Baldwin School | G | d | K | 12 |
| PA | Bryn Mawr | The Shipley School | C | d | PS | 12 |
| PA | Erie | The Erie Day School | C | d | K | 8 |
| PA | Fort Washington | Germantown Academy | C | d | PS | PG |
| PA | Harrisburg | The Harrisburg Academy | C | d | K | 12 |
| PA | Haverford | Friends School | C | d | PS | 6 |
| PA | Haverford | The Haverford School | B | d | K | 12 |
| PA | Jenkintown | Abington Friends School | C | d | K | 12 |
| PA | Kennett Square | Upland Country Day School | C | d | PS | 9 |
| PA | Kimberton | Kimberton Farms School Inc | C | d | PS | 12 |
| PA | Kingston | Wyoming Seminary | C | db | PS | PG |
| PA | Lahaska | The Buckingham Friends School | C | d | K | 8 |
| PA | Lancaster | Lancaster Country Day School | C | d | PS | 12 |
| PA | Ligonier | Valley School of Ligonier | C | d | K | 8 |
| PA | Lititz | Linden Hall School | G | bd | 7 | PG |
| PA | Malvern | Malvern Preparatory School | B | d | 7 | 12 |
| PA | Malvern | The Phelps School | B | b | 7 | 12 |
| PA | Meadowbrook | The Meadowbrook School | C | d | PS | 6 |
| PA | Mercersburg | The Mercersburg Academy | C | bd | 9 | 12 |
| PA | Merion | The Episcopal Academy | C | d | PS | 12 |
| PA | Merion Station | Akiba Hebrew Academy | C | d | 6 | 12 |
| PA | Miquon | The Miquon School | C | d | PS | 6 |
| PA | New Bloomfield | Carson Long Institute | B | b | 6 | 12 |
| PA | New Hope | Solebury School | C | bd | 7 | 12 |
| PA | Newtown | George School | C | bd | 9 | 12 |
| PA | Newtown, Bucks Co. | Newtown Friends School | C | d | K | 8 |
| PA | Paoli | Church Farm School | B | b | 7 | 12 |
| PA | Pennsburg | Perkiomen School | C | bd | 8 | PG |
| PA | Philadelphia | Chestnut Hill Academy | B | d | K | 12 |
| PA | Philadelphia | Friends' Central School | C | d | PS | 12 |
| PA | Philadelphia | Friends Select School | C | d | K | 12 |
| PA | Philadelphia | Germantown Friends School | C | d | K | 12 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| PA | Philadelphia | Penn Center Academy | C | d | 9 | 12 |
| PA | Philadelphia | The Philadelphia School | C | d | K | 8 |
| PA | Philadelphia | St. Barnabas Episcopal School | C | d | 1 | 6 |
| PA | Philadelphia | Saint Joseph's Preparatory Sch | B | d | 9 | 12 |
| PA | Philadelphia | Springside School | G | d | PS | 12 |
| PA | Philadelphia | William Penn Charter School | B | d | K | 12 |
| PA | Pittsburgh | The Ellis School | G | d | K | 12 |
| PA | Pittsburgh | Fox Chapel Country Day School | C | d | PS | 5 |
| PA | Pittsburgh | St. Edmund's Academy | B | d | PS | 8 |
| PA | Pittsburgh | Shady Side Academy | C | db | K | 12 |
| PA | Pittsburgh | The Winchester-Thurston School | G | d | K | 12 |
| PA | Pottstown | The Hill School | B | bd | 8 | 12 |
| PA | Pottstown | The Wyndcroft School | C | d | PS | 8 |
| PA | Radnor | The Woodlynde School | C | d | K | 12 |
| PA | Rosemont | Agnes Irwin School | G | d | K | 12 |
| PA | Rosemont | The Hill Top Prep. Sch. Inc. | C | d | 7 | PG |
| PA | Saltsburg | The Kiski School | B | bd | 9 | 12 |
| PA | Scranton | Scranton Preparatory School | C | d | 9 | 12 |
| PA | Sewickley | Sewickley Academy | C | d | PS | 12 |
| PA | Tyrone | The Grier School | G | b | 7 | 12 |
| PA | Villa Maria | Villa Maria High School | G | db | 9 | 12 |
| PA | Wayne | Valley Forge Military Academy | B | b | 7 | PG |
| PA | Westtown | Westtown School | C | db | K | 12 |
| PA | Wynnewood | Montgomery Country Day School | C | d | K | 8 |
| PA | York | York Country Day School | C | d | PS | 12 |
| RI | Barrington | St. Andrew's School | C | db | 7 | 12 |
| RI | East Greenwich | Rocky Hill School | C | d | K | 12 |
| RI | East Providence | The Gordon School | C | d | PS | 8 |
| RI | East Providence | The Providence Cty. Day School | B | d | 5 | 12 |
| RI | Newport | St. George's School | C | bd | 9 | 12 |
| RI | Portsmouth | Portsmouth Abbey School | B | bd | 8 | 12 |
| RI | Providence | Lincoln School | G | d | PS | 12 |
| RI | Providence | Moses Brown School | C | db | PS | 12 |
| RI | Providence | The Wheeler School | C | d | PS | 12 |
| SC | Aiken | Aiken Preparatory School | B | bd | 4 | 9 |
| SC | Camden | Camden Military Academy | B | b | 7 | 12 |
| SC | Charleston | Porter-Gaud School | C | d | 1 | 12 |
| SC | Columbia | Heathwood Hall Episcopal Sch | C | d | K | 12 |
| SC | Greenville | Christ Church Episcopal School | C | d | K | 12 |
| SC | Hilton Head Island | Sea Pines Academy | C | d | 1 | 12 |
| SC | Myrtle Beach | Coastal Academy | C | d | PS | 12 |
| SC | Spartanburg | The Spartanburg Day School | C | d | PS | 12 |
| TN | Bell Buckle | Webb School | C | bd | 7 | 12 |
| TN | Brentwood | Brentwood Academy | C | d | 7 | 12 |
| TN | Chattanooga | The Baylor School | B | db | 7 | 12 |
| TN | Chattanooga | The Bright School | C | d | K | 6 |
| TN | Chattanooga | Girls' Preparatory School | G | d | 7 | 12 |
| TN | Chattanooga | The McCallie School | B | db | 7 | 12 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| TN | Clarksville | The Clarksville Academy | C | d | PS | 12 |
| TN | Franklin, | Harpeth Academy | C | d | K | 6 |
| TN | Germantown | Lausanne School | G | db | K | 12 |
| TN | Jackson | The Episcopal Day School | C | d | PS | 10 |
| TN | Knoxville | The Webb School of Knoxville | C | d | 5 | 12 |
| TN | Memphis | The Hutchison School | G | d | PS | 12 |
| TN | Memphis | Memphis University School | B | d | 7 | 12 |
| TN | Memphis | St. Mary's Episcopal School | G | d | PS | 12 |
| TN | Nashville | Ensworth School | C | d | K | 8 |
| TN | Nashville | Montgomery Bell Academy | B | d | 7 | 12 |
| TN | Nashville | The Oak Hill School | C | d | K | 6 |
| TN | Nashville | University School of Nashville | C | d | K | 12 |
| TN | Nashville | Harding Academy | C | d | 1 | 8 |
| TN | Nashville | The Harpeth Hall School | G | d | 6 | 12 |
| TN | St. Andrews | St. Andrew's-Sewanee School | C | db | 7 | 12 |
| TX | Austin | Saint Stephen's Episcopal Sch. | C | bd | 7 | 12 |
| TX | Dallas | The Hockaday School | G | db | PS | 12 |
| TX | Dallas | The Lamplighter School | C | d | PS | 4 |
| TX | Dallas | St. Mark's School of Texas | B | d | 1 | 12 |
| TX | Dallas | The Winston School | C | d | 2 | 9 |
| TX | Dallas | The Greenhill School | C | d | PS | 12 |
| TX | Denton | The Selwyn School | C | db | K | 12 |
| TX | Fort Worth | Fort Worth Country Day School | C | d | K | 12 |
| TX | Fort Worth | Trinity Valley School | C | d | K | 12 |
| TX | Galveston | Trinity Episcopal School | C | d | PS | 8 |
| TX | Harlingen | Marine Military Academy | B | b | 8 | PG |
| TX | Houston | The Kinkaid School | C | d | PS | 12 |
| TX | Houston | St. John's School | C | d | K | 12 |
| TX | Midland | Trinity School of Midland | C | d | PS | 9 |
| TX | San Antonio | St. Luke's Episcopal School | C | d | PS | 5 |
| TX | San Antonio | Saint Mary's Hall | G | db | PS | 12 |
| TX | San Antonio | Texas Military Institute | C | db | 6 | 12 |
| TX | San Marcos | San Marcos Baptist Academy | C | bd | 5 | 12 |
| UT | Mount Pleasant | Wasatch Academy | C | b | 9 | 12 |
| UT | Salt Lake City | Rowland Hall-Saint Marks Sch | C | d | PS | 12 |
| VA | Alexandria | Ascension Academy | C | d | 1 | 12 |
| VA | Alexandria | Episcopal High School | B | b | 9 | 12 |
| VA | Alexandria | St. Agnes School | G | d | K | 12 |
| VA | Alexandria | St. Stephen's School | B | d | 3 | 12 |
| VA | Boyce | Powhatan School | C | d | PS | 8 |
| VA | Charlottesville | St. Anne's-Belfield School | C | d | PS | 12 |
| VA | Chatham | Chatham Hall | G | bd | 9 | 12 |
| VA | Christchurch | Christchurch School | C | bd | 9 | PG |
| VA | Dyke | Blue Ridge School | B | b | 9 | 12 |
| VA | Fork Union | Fork Union Military Academy | B | b | 5 | PG |
| VA | Greenway | The Madeira School | G | bd | 9 | 12 |
| VA | Leesburg | Loudoun Country Day School | C | d | PS | 8 |
| VA | Lynchburg | Seven Hills School | G | d | 6 | 12 |

| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| VA | Lynchburg | Virginia Episcopal School | B | bd | 7 | PG |
| VA | Martinsville | Carlisle School | C | d | K | 12 |
| VA | McLean | The Langley School | C | d | PS | 8 |
| VA | McLean | The Potomac School | C | d | PS | 9 |
| VA | Middleburg | Foxcroft School | G | bd | 9 | 12 |
| VA | Middleburg | The Hill School | C | d | K | 8 |
| VA | Newport News | Hampton Roads Academy | C | d | 6 | 12 |
| VA | Norfolk | Norfolk Academy | C | d | 1 | 12 |
| VA | Norfolk | Norfolk Collegiate School | C | d | 1 | 12 |
| VA | Orange | Grymes Memorial School | C | d | PS | 8 |
| VA | Petersburg | Bollingbrook School | C | d | K | 12 |
| VA | Richmond | Benedictine High School | B | d | 9 | 12 |
| VA | Richmond | The Collegiate Schools | C | d | K | 12 |
| VA | Richmond | St. Catherine's School | G | db | K | 12 |
| VA | Richmond | St. Christopher's School | B | d | K | 12 |
| VA | Richmond | St. Gertrude High School | G | d | 9 | 12 |
| VA | Roanoke | North Cross School | C | d | K | 12 |
| VA | Staunton | Stuart Hall | G | bd | 07 | 12 |
| VA | Tappahannock | St. Margaret's School | G | bd | 8 | 12 |
| VA | Warrenton | Highland School | C | d | K | 8 |
| VA | Woodberry Forest | Woodberry Forest School | B | b | 9 | 12 |
| VT | Lyndon Center | Lyndon Institute | C | d | 9 | 12 |
| VT | Manchester | Burr and Burton Seminary | C | d | 9 | 12 |
| VT | Putney | The Putney School | C | bd | 9 | 12 |
| VT | Saxtons River | Vermont Academy | C | bd | 9 | 12 |
| VT | St. Johnsbury | St. Johnsbury Academy | C | db | 9 | PG |
| WA | Bellevue | Forest Ridge School | G | d | 6 | 12 |
| WA | Redmond | The Overlake School | C | d | 7 | PG |
| WA | Seattle | The Bush School | C | d | K | 12 |
| WA | Seattle | Epiphany School | C | d | PS | 6 |
| WA | Seattle | Lakeside School | C | d | 5 | 12 |
| WA | Seattle | The Little School | C | d | PS | 8 |
| WA | Seattle | University Preparatory Academy | C | d | 7 | 12 |
| WA | Spokane | St. George's School | C | d | K | 12 |
| WA | Tacoma | Annie Wright School | G | db | PS | 12 |
| WA | Tacoma | Charles Wright Academy | C | d | PS | 12 |
| WI | Beaver Dam | Wayland Academy | C | bd | 8 | 12 |
| WI | Delafield | St. John's Military Academy | B | b | 7 | 12 |
| WI | Hartland | University Lake School | C | d | 5 | 12 |
| WI | Lake Geneva | Northwest. Mili. & Naval Acad. | B | bd | 7 | 12 |
| WI | Milwaukee | University School of Milwaukee | C | d | PS | 12 |
| WI | Racine | The Prairie School | C | d | PS | 12 |
| WV | Wheeling | Linsly Institute | B | db | 5 | 12 |
| WV | Wheeling | Wheeling Country Day School | C | d | PS | 8 |

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| STATE | CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|---|
| GU | Agana | St. John's Episcopal Prep Sch. | C | d | PS | 9 |
| PR | Fajardo | Fajardo Academy | C | d | K | 7 |
| PR | Ponce | The Caribbean School | C | d | PS | 12 |
| PR | San Juan | Caribbean Consolidated Schs. | C | d | PS | 12 |
| PR | Santurce | Robinson School | C | d | PS | 12 |
| PR | Santurce | Saint John's School | C | d | PS | 12 |
| VI | St Croix | Good Hope School | C | d | PS | 12 |
| VI | St Croix | St. Dunstan's Episcopal School | C | d | K | 12 |
| VI | St. Thomas | All Saints Cathedral School | C | d | PS | 12 |
| VI | St. Thomas | Antilles School | C | d | PS | 12 |

## AFFILIATE MEMBER SCHOOLS

(Located outside of the U.S. and its territories)

| COUNTRY/CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|
| AUSTRALIA | | | | | |
| Balwyn, Victoria | Camberwell Grammar School | B | d | K | 12 |
| Bathurst NSW | All Saint's College | C | bd | 7 | 12 |
| Canberra | Canberra Grammar School | B | db | PS | 12 |
| Glen Waverley, Victoria | Wesley College | B | d | K | 12 |
| Ivanhoe | Ivanhoe Grammar School | B | d | K | 12 |
| Kew | Methodist Ladies' College | G | db | PS | 12 |
| Newton, Victoria | The Geelong College | C | db | K | 12 |
| North Sydney, NSW | Sydney Church of Eng. Grammar Schl. | B | db | 4 | 12 |
| Prahran | Wesley College, Prahran Campus | | | | |
| Stanmore | Newington College | B | db | K | 12 |
| BAHAMAS | | | | | |
| Nassau | St. Andrew's School | C | d | PS | 12 |
| BELGIUM | | | | | |
| Brussels | International School of Brussels | C | d | PS | PG |
| BERMUDA | | | | | |
| Pembroke | The Bermuda High School for Girls | G | d | K | 12 |
| | Saltus Grammar School | B | d | K | 12 |
| BRAZIL | | | | | |
| Rio de Janeiro | Escola Amer. Do Rio De Janeiro | C | d | K | PG |
| Sao Paulo | Assoc. Escola Grad De Sao Paulo | C | d | PS | 12 |
| CANADA | | | | | |
| Alberta | | | | | |
| Okotoks | Strathcona-Tweedsmuir School | C | d | 1 | 12 |
| British Columbia | | | | | |
| Vancouver | Crofton House School | G | db | 1 | 12 |
| | St. George's School | B | db | 2 | 12 |
| | York House School | G | d | K | 12 |
| Manitoba | | | | | |
| Winnipeg | Balmoral Hall School for Girls | G | db | K | 12 |
| New Brunswick | | | | | |
| Rothsey | The Netherwood-Rothsey Sch/Girls | G | bd | 7 | 12 |
| Ontario | | | | | |
| Aurora | St. Andrew's College | B | bd | 7 | PG |
| Belleville | Albert College | C | bd | 7 | PG |
| Brockville | Grenville Christian College | C | bd | 7 | PG |
| Hamilton | Hillfield-Strathallan College | C | d | PS | PG |
| Lakefield | Lakefield College School | B | bd | 7 | PG |
| Oakville | Appleby College | B | bd | 4 | PG |
| Ottawa | Ashbury College | B | db | 5 | PG |
| Port Hope | Trinity College School | B | b | 7 | PG |
| St. Catherine's | Ridley College | C | bd | 6 | PG |

Cont'd next page

| COUNTRY/CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|
| Toronto | The Bishop Strachan School | G | db | PS | PG |
| | Branksome Hall | G | db | K | PG |
| | Havergal College | G | db | PS | PG |
| | St. Clement's School | G | d | 1 | PG |
| | The Toronto French School | C | d | PS | PG |
| | Upper Canada College | B | db | 3 | PG |
| Willowdale | The Crescent School | B | d | 5 | PG |
| Quebec | | | | | |
| Lennoxville | Bishop's College School | C | bd | 7 | 12 |
| Montreal | Convent of the Sacred Heart | G | db | 7 | 11 |
| | Miss Edgar's & Miss Cramp's School | G | d | 1 | 11 |
| | Lower Canada College | B | d | 3 | 12 |
| | The Priory School | C | d | K | 6 |
| | St. George's Schl of Montreal | C | d | PS | 11 |
| | Trafalgar School for Girls | G | d | 7 | 11 |
| | Weston School Incorporated | C | d | 1 | 11 |
| Stanstead | Stanstead College | C | bd | 7 | 12 |
| Westmount | Selwyn House School | B | d | 1 | 11 |
| | The Study | G | d | K | 11 |
| Saskatchewan | | | | | |
| Wilcox | Athol Murray College of Notre Dame | C | b | 9 | 12 |
| COLUMBIA | | | | | |
| Bogota | Colegio Nueva Granada | C | d | PS | PG |
| EGYPT | | | | | |
| Alexandria | Schutz American School | C | db | PS | 12 |
| Cairo | Cairo American College | C | d | K | 12 |
| ENGLAND | | | | | |
| Kingston-on-Thames, Surrey | Marymount International School | G | bd | 7 | 12 |
| London | The American School in London | C | d | K | 12 |
| | The American School in Switzerland, TASIS England (see also SWITZERLAND listing) | C | bd | 5 | 12 |
| FRANCE | | | | | |
| St.-Cloud | American School of Paris | C | d | K | 12 |
| GERMANY | | | | | |
| Frankfurt | Frankfurt International School | C | d | K | 12 |

| COUNTRY/CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|
| GREECE | | | | | |
| Athens | American Community Schls of Athens, Inc. | C | d | PS | 12 |
| HAITI | | | | | |
| Port-au-Prince | Union School | C | d | PS | 12 |
| HONG KONG | Hong Kong International School | C | d | K | 12 |
| INDIA | | | | | |
| New Delhi | The American Embassy School | C | d | PS | 12 |
| ITALY | | | | | |
| Rome | American Overseas School of Rome | C | d | PS | 12 |
| | St. Stephen's School | C | db | 9 | PG |
| JAPAN | | | | | |
| Nagoya | Nagoya International School | C | d | PS | PG |
| Tokyo | The American School in Japan | C | d | PS | PG |
| KOREA | | | | | |
| Seoul | Seoul Foreign School | C | d | PS | 12 |
| LEBANON | | | | | |
| Beirut | International College | C | d | PS | PG |
| MOROCCO | | | | | |
| Tangier | American School of Tangier | C | db | K | 12 |
| NORWAY | | | | | |
| Madla | Stavanger American School | C | d | K | 12 |
| PARAGUAY | | | | | |
| Asuncion | American School of Asuncion | C | d | PS | 12 |
| PHILLIPINES | | | | | |
| Baguio City | Brent School | C | db | PS | 12 |
| Rizal | International School | C | d | K | 12 |

| COUNTRY/CITY | SCHOOL | STU | SCH | LG | HG |
|---|---|---|---|---|---|
| SAUDI ARABIA | | | | | |
| Dhahran | Aramco Schools | C | d | K | 9 |
| SOUTH AFRICA | | | | | |
| Johannesburg | St. Barnabas College | C | db | 7 | 12 |
| SWITZERLAND | | | | | |
| Leysin | Leysin American School | C | bd | 9 | 12 |
| Montagnola-Lugano | The American School in Switz. | C | bd | 7 | 12 |
| Zugerburg | American School of Institut Montana | B | bd | 6 | 12 |
| TAIWAN | Taipei American School | C | d | K | 12 |
| TURKEY | | | | | |
| Istanbul | Robert College | C | db | 6 | 12 |
| U.S.S.R. | | | | | |
| Moscow | Anglo-American School | C | d | K | 9 |
| VENEZUELA | | | | | |
| Caracas | S.A. Escuela Campo Alegre | C | d | PS | 12 |

## MEMBER ASSOCIATIONS

A variety of associations and organizations concerned with independent school education are affiliated with NAIS as nonvoting members. The nature and extent of their relationship with NAIS varies considerably. For purposes of classification, they are listed below in three categories. Titles refer to positions held in associations, not in schools; the president of the association is listed only if there is no other individual to contact.

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**ARIZONA ASSOCIATION OF INDEPENDENT ACADEMIC SCHOOLS**

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**National Association of Wholesaler-Distributors,**
*Washington, D.C., August 17, 1983.*

Hon. **Fortney H. Stark,**
*Chairman, Subcommittee on Select Revenues, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.*

**Dear Mr. Chairman:** This is to provide, for the record, the views of the National Association of Wholesaler-Distributors on H.R. 3525, "Permanent Tax Treatment of Fringe Benefits Act of 1983."

NAW is a federation of 120 national commodity line associations, which in turn are composed of over 45,000 merchant wholesaler-distributors located throughout the 50 states. Wholesale distribution is a major segment of the United States economy with sales forecast by the United States Department of Commerce to reach over $1 trillion this year. The industry provides employment to over 4.5 million individuals. Our membership accounts for approximately 60 percent of industry sales and employment.

NAW members distribute virtually every conceivable type of consumer and industrial product. They purchase goods from manufacturers and resell them to retailers and to industrial, institutional, commercial and other types of business users, as well as to the government.

The majority of this merchandise passes through the wholesaler-distributor's warehouse to the customer in its original form without the package being opened. A small proportion of the merchandise which our members distribute is assembled before shipment or modified to a customer's specifications. Wholesaler-distributors in certain commodity-lines also perform installation, and/or subsequent servicing activities.

A significant portion of the merchandise which our members sell is direct-shipped from the manufacturer to the customer without ever passing through the distributor's warehouse.

Despite the impressive aggregate statistics related above, the wholesaler distribution industry is preponderantly composed of small to medium size businesses. The average NAW members' sales volume is approximately $5 million, and has 40 to 50 employees. It is through this size of business that the vast bulk of products move to market in our economy.

Small business is at a disadvantage in its ability to offer prospective management talent, either from the outside or from within, remuneration in the form of non-cash current non-taxable fringe benefits available to its large counterpart.

There are non-qualified options, stock appreciation rights, performance shares, restricted stock, phantom stock and numerous combinations of the foregoing just to name a few. These plans and those like them offer no attraction to employees of small business. Secondly, family held or closely held businesses are unnecessarily diluted by these plans and they are therefore not suitable for small business.

Non-abusive use of fringe benefits is frequently the only area in which the majority of our members can compete. We are therefore opposed to H.R. 3525. This legislation, rather than solving a long standing problem, narrows the issue to such an extent as to give the Treasury Department a carte blanche to attack corporate taxpayers on the fringe benefit issue. The de minimis fringe issue becomes wholly subjective and will create issues on every audit where any fringe is available.

We appreciate the opportunity to provide the views of the wholesale-distribution industry to the Subcommittee on this important issue.

Sincerely,

**John H. Fitch, Jr.**
*Vice President, Government Relations.*

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**Palatine, Ill.,** *July 7, 1983.*

Hon. **Daniel Rostenkowski,**
*Chairman, Committee on Ways & Means,*
*Longworth House Office Building, Washington, D.C.*

**Dear Congressman:** Would you please enter into the record my strong objection to the proposed taxation of employee fringe benefits, H.R. 943.

I believe this tax is unfair, unadministrable, and a potential for increased bureaucratic costs.

Thank you for your consideration.

Sincerely,

**Jean F. Roegge.**

CARNEGIE-MELLON UNIVERSITY,
*Pittsburgh, Pa.*

Re H.R. 3525.

Mr. JOHN J. SALMON,
*Chief Counsel, Committee on Ways and Means,*
*U.S. House of Representatives, Washington, D.C.*

DEAR MR. SALMON: This letter is in support of most of the provisions of H.R. 3525, the "Permanent Tax Treatment of Fringe Benefits Act of 1983", insofar as they apply to educational benefits for children of faculty at colleges and universities. However, I understand that the benefit offered by some institutions that allows payment to children who attend other institutions than the one of parental employment, is not included in the tax exempt category. I would like to offer here some reasons why the act should include such programs, which I will refer to here as "tuition grants", with the understanding that tuition exchange programs are included as well.

I think Congress accepts the premise that it should take every reasonable opportunity to promote the cause of quality education in the United States at all educational levels, particularly if the real cost to the government is minimal compared to the return. The tuition grants benefit is such a program. Let me enumerate the reasons that I believe this to be so. 1. The economic position of the higher education faculty has steadily slipped during the last 13 years, so that the situation is similar to the depressed condition before the increases in salaries that began in the late 1950's. That is one reason that bright young graduates in the sciences and engineering are leaving school at the B.S. level for industry instead of continuing their education. Both the industrial and educational future of the country are ill-served by this largely economic choice. Colleges and Universities have few fringe benefits or perquisites to offer potential employees compared to those available in the corporate world, but they can offer one that is of great importance to young potential faculty: the chance of a first rate education for their children, even if salary levels are too low to buy the best on their own. That very benefit was of importance to me 25 years ago. The "transportability" of the benefit was crucial, since my institution is small and specialized—predictably not suitable for all my potential children. Without the tuition grant benefit, or with a substantial tax bite into money I would never see directly, the fringe benefit would have been a minor consideration.

2. Exclusion of tuition grant or exchange programs encourages enrollment of faculty children in the "home" institution. My experience convinces me without doubt that the presence of a significant number of faculty children in a small institution (and most affected institutions are not the 30,000 student State Universities) has a negative effect on educational quality. All generalizations about education are hard to support with numbers and unassailable research, and I doubt that any research has been done on this subject. My own experience as a faculty child at a 1800 student campus, where my father taught all my friends, association with other "faculty brats" there, my experience as a faculty member teaching other faculty's children, and as a father of a child enrolled at my institution, leave no doubt of the general undesirability of increasing the frequency of such arrangements.

3. When families have been eligible for guaranteed loans, the loan is made to the child, who begins to pay it off after graduation with the initial earnings of employment. It is difficult to see why a payment of a tuition grant is not of the same kind: a payment to the recipient and benefactor of the grant, the student. The current level of faculty salaries in the U.S. does not support the argument that the faculty member will simply pay the tax and send the student to the same institution: not with several children, not with continued lack of adequate remuneration.

4. There seems to be no public purpose served be denying inclusion of tuition grants in the tax exemptions of H.R. 3525. The suspicion arises that perhaps the exclusion is another example of a type of "meanness" previously exhibited by the notorious "tenured Professor's exemption" to the age 70 retirement rule of several years ago. No doubt some institutions believe money is to be saved by paying only the marginal costs associated with enrolling faculty children in the home institution. Considering my point above, this attitude would be very self-defeating, and I hope it has not been advanced as an aid to institutional finance. Or, if it has been offered, I hope it is quickly rejected.

I also understand that H.R. 3525 proposes to tax tuition grants to graduate teaching and research assistants. To do so would be an even more obvious and damaging error than the taxation of faculty tuition grants. Private institutions as well as a great many State Universities and Colleges would be forced to pay this tax for the student by increasing compensation until the take-home pay reaches the present very minimal, spartan, near poverty-line level. The money for this additional salary would come from increased tuition, to pay the teaching assistants, and from government research grants (mainly in the engineering and science disciplines), themselves already substantially depressed in educational and research buying power from the 1960's.

With respect to this last subject, I know the Universities will be able to bring the facts to the attention of the Committee, so I will not belabor the point further. With respect to faculty benefits, only faculty and their children probably understand the negative impact of the proposed change, so we must speak loudly for ourselves, I hope not against the voices of our administrations.

Sincerely,

ROBERT T. SCHUMACHER,
*Professor of Physics.*

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## STATEMENT OF TAX EXECUTIVES INSTITUTE, INC.

Tax Executives Institute, Inc. (TEI) supports the Subcommittee's effort to clarify the principles applicable to the taxation of non-cash employer provided items, which are more commonly referred to as fringe benefits. Since the Department of the Treasury's first attempt to establish general rules with respect to the tax treatment of such items in 1975, the treatment of fringe benefits has been marked by confusion and disagreement among responsible authorities. TEI does not underestimate the difficulty this task has posed for the Treasury Department and the Internal Revenue Service, and for this reason, TEI supports the effort to resolve the issues by legislation. Ideally such legislation should ensure horizontal equity between taxpayers and should provide clear and easily administrable rules. Although H.R. 3525 moves Congress toward these goals, the Subcommittee should be aware of the need for further clarification and refinement. As the following comments make clear, Tax Executives Institute believes certain very important aspects of H.R. 3525 should be clarified or amended to more fairly tax fringe benefits.

### GENERAL COMMENTS

The four general rules provided by H.R. 3525 parallel in substantial part the general rules provided by the Discussion Draft Bill prepared by the Staff for the Task Force on Employee Benefits in 1979, "Report and Discussion Draft Bill," 96th Cong., 1st Sess. (Feb. 15, 1979). TEI has already commented extensively on previous efforts to resolve the fringe benefits issue and refers the Subcommittee to its statement on the Task Force Report, which was submitted on August 31, 1978, as well as its subsequent submissions to the Department of the Treasury on June 15, 1981, and to the Internal Revenue Service on November 1, 1982. Copies of all three submissions are attached for the Subcommittee's review and consideration.

### *No-additional-cost service rule*

TEI supports the principle that taxable income should not be recognized under circumstances where an employee is provided a benefit with respect to which the employer incurs no significant incremental cost. This should hold true regardless of whether an employee is being provided goods or services. We submit, moreover, that the provision as drafted is unrealistically narrow and likely to create significant administrative problems if limited to items provided by the employer in the specific trade or business in which an employee happens to be performing services. The proposed rule disregards the historical practice of companies to provide all employees of the company or the affiliated group with similar benefits. (Indeed, in some cases contracts may require such a non-discriminatory approach.) In addition, identification of specific trades or businesses within a company or affiliated group could well engender endless audit disputes and poses significant administrative difficulties for those who will be forced to determine whether benefits are taxable or non-taxable based on each individual employee's status, especially where that status could change several times during the year. One wonders, for instance, whether a coporate staff employee is engaged in all or none of the several trades or businesses of a consolidated group of U.S. companies.

TEI further submits that it is theoretically incorrect and inequitable to exclude from the determination of whether the employer has incurred additional cost those amounts that the employee may have paid to reimburse the employer. This approach runs counter to that recommended by the Committee's 1978 Task Force whose draft bill would have provided that "any consideration (other than the performance of services) furnished by the employee for such benefit" was to be taken into account.

Finally, TEI believes that administration of the no-additional-cost rule would be made exceedingly difficult by requiring that the employer not forgo any revenue in making the fringe benefit available to the employee. The question whether revenue has been forgone would assuredly produce honest differences of opinion and audit disputes and would effectively require an affirmative showing by the employer that revenue has not been forgone; this in turn could entail establishment of an entirely new set of employer records related to use of capacity. It also appears inconsistent with the substantial dollar "qualified tuition reduction" provision of the bill. Such a requirement would be onerous and should not be imposed on employers.

*Qualified discount rule*

TEI supports the principle that taxable income should not include discounts offered by an employer to employees. The bill's 20 percent discount rule, however, is likely to prove adminstratively difficult if not unworkable in practice and is not, in any event, an appropriate test for judging the taxable status of an employee discount. Consequently, TEI recommends that H.R. 3525 be amended to provide that a discount will be taxable only where the discount results in a price to the employee that does not permit the employer to recover the incremental cost of providing the particular merchandise or services. Such a rule would clearly be administratively more workable.

In any event, should the Subcommittee decide to retain a particular percent discount rule, TEI recommends that the special provision for determining the percentage of the employer's profit be modified to focus on the employer's profit on the specific product provided to the employee. The rationale for requiring, in effect, standardized discounts in each trade or business is muddled at best where the employer may in fact experience larger or smaller profits on various items and therefore find it administratively simpler to make products available at incremental cost or to offer employees a standardized company-wide discount.

Finally, both direct and indirect discounts to employees should be treated in a similar manner. By indirect discounts, we include cash rebates given employees by employers for the purchase of employer manufactured goods from unrelated retail distributors of the goods.

*Working condition rule*

The bill properly recognizes that taxable income should not include any working condition items provided to the employee to facilitate performance of his duties. As explained more fully below, however, the bill provides that certain working condition fringes (namely, free parking) will be taxable unless provided on a non-discriminatory basis. Such a special rule is not appropriate with respect to any working condition fringe, since by their very nature working conditions are tailored to particular individuals and are provided by the employer to enable the employee to perform his duties and not to benefit the employee. Different employees will have different responsibilities and, consequently, require different working conditions. That particular employees are officers or highly compensated ought not be the basis for a statutory distinction making the taxability of working conditions turn on the employee's rank.

*De minimis rule*

TEI supports the principle that de minimis fringe benefits should not be included in the employee's taxable income. We submit, however, that the bill's aggregation rule with respect to de minimis fringe benefits should be eliminated. It defies logic to recognize, as H.R. 3525 properly does, that certain items are so small that accounting for them would be unreasonable or impracticable and then to simultaneously require the aggregation of such items. If an item is too small to be accounted for, it is too small for any purpose, including aggregation.

## COMMENTS ON SPECIAL RULES

*Recreational facilities*

TEI believes the approach of H.R. 3525 with respect to on-premise recreational facilities is unsound as a matter of policy. Recreational facilities often serve substantial and legitimate employer purposes. Providing employees a means of regular exercise serves to maintain their health and alertness, to improve job performance and employee morale, and to reduce lost time. Of course, this is in addition to all the benefits the employer receives from the business handled by the employees as they use the facilities together. The nexis between employer provision of gymnasiums and similar facilities and legitimate employer business needs is undeniable. Consequently, TEI objects to the bill's proposed inclusion of the value of use or availability of either on-premises or off-premises recreational facilities in employee income and to its even more radical alternative of disallowing (on an elective basis) the employer's deductions with respect to such facilities.

### *Employee parking*

TEI agrees that employer-provided parking can properly be viewed as an item excluded from income as a working condition fringe benefit. We submit, however, that the inclusion of an anti-discrimination requirement for application of this rule is inappropriate. Parking is ordinarily provided to employees because the employer has determined that the employee may need to use his car during working hours for employer business. All employee, however, do not have such job requirements. For example, typing pool personnel may have duties that seldom require them to be out of the building. On the other hand, other personnel (including senior management, middle managment, and professional staff) very frequently need to leave company offices to travel to other company locations or to meetings with customers, suppliers, or others away from the employer's offices. If parking is provided as a working condition to employees, it (like security or any other working condition item) ought to be non-taxable, irrespective of whether it is provided to all employees or any specific group TEI strongly recommends deletion of the non-discrimination requirement from the parking rule.

## VALUATION

Turning away from H.R. 3525's technical provisions, we should like to now address the question of how taxable fringe benefits should be valued. The technical explanation of the bill states that any benefit not qualifying for exclusion under the bill or under other provisions of the Internal Revenue Code would be taxable to the recipient under section 61 "using the fair market value standard." It is respectfully submitted, however, that this statement incorrectly generalizes the current law of valuation for tax purposes which (in fact) provides for valuation of a benefit by applying one of a number of standards, only one of which is fair market value. See generally Elwood & Gleicher, 394 T.M., "Employee Fringe Benefits" at A-51 to A-55.

Among the alternative standards clearly permitted by current law are incremental employer cost and allocable employer cost. TEI submits that incremental employer cost is the preferred approach for determining the amount of income realized by an employee who is the recipient of a taxable fringe benefit item. The valuation question is discussed in depth in TEI's November 1, 1982, letter to Commissioner of Internal Revenue Roscoe L. Egger, Jr. (a copy of which, as already noted, is attached).

We submit that use of the incremental cost standard is justified by its ease of application and its compatibility with other management reporting requirements. Indeed, under H.R. 3525, employers must already make an incremental cost determination in order to comply with the no-additional-cost provision, since in determining whether a benefit falls within the scope of that provision the employer must determine (i) the employer's base cost and (ii) whether any additional cost was incurred in making the item available to the employee. There is no compelling reason for putting employers to a further calculation, which could be highly speculative. For example, a fair market value determination requires knowledge any employer may not have of discounts, restrictions, and other elements that could influence the price an item might bring in the marketplace. Other difficulties are presented by full cost allocation which would necessitate calculations an employer may be unable to make until after the close of the year when the total of all costs to be allocated are known.

Finally, introduction of the fair market value standard would break the parallel treatment between the employee and the employer, since the effect would be to impute income to the employee in excess of that expended by the employer. H.R. 3525 should be amended to limited the amount of a benefit taxable to an employee to an amount not greater than the employer's incremental cost. This standard, which was endorsed by the American Institute of Certified Public Accountants in 1979, is supported by existing case law as well as by administrative considerations.

## WITHHOLDING

TEI wholeheartedly supports the provision of H.R. 3525 stating that any benefits excluded from taxation under the bill will not be treated as "wages" subject to income tax withholding or to FICA or FUTA taxes. TEI recommends, moreover, that the bill should be modified to provide further guidance in the payroll tax area (where the employer acts principally as the government's collecting agent). Specifically, the bill should provide that even where certain fringe benefit items are taxable to the employee (because they are not covered by H.R. 3525 or any provision of the Code) those items will not be treated as "wages" for income tax withholding, FICA, and FUTA purposes. Such a rule would recognize that even taxable fringe benefits are frequently provided for valid non-compensatory business reasons. See *Central Illinois Public Service Co.* v. *United States,* 435 U.S. 21 (1978). It would also recognize the significant uncertainty often surrounding an item's value and the administrative difficulties and employer could encounter in attempting to timely comply with the Code's withholding requirements.

## EFFECTIVE DATE

TEI submits that the bill's proposed effective date (January 1, 1984) is unrealistic. Even assuming the bill is promptly enacted, employers will not have adequate time before the first of the year to modify their existing payroll and accounting practices and implement the procedures required by the bill. Consequently, TEI recommends that, to allow employers adequate time to ensure compliance with its requirements, the legislation's effective date be deferred until the later of January 1, 1985, or the second calendar year beginning after the date of enactment.

# Statement of Tax Executives Institute Submitted to Special Task Force on Employee Fringe Benefits of Ways and Means Committee

Tax Executives Institute is a not-for-profit corporation with over 3200 individual professional members, tax officers representing 2000 of the leading corporations of North America. It is dedicated to the principle that administration of, and compliance with, the tax laws in accordance with the highest standards of professional competence and integrity in an atmosphere of mutual trust and confidence between business managements and tax administrators promotes uniform enforcement of taxes, minimization of the costs of administration and compliance to the benefit of both government and taxpayer.

The problem of taxability of fringe benefits is one which has perplexed both American businessmen and the Internal Revenue Service for many years. In order to insure the integrity, simplicity and uniformity of the tax system, to facilitate compliance and to provide certainty to businessmen as to the consequence of their actions, clear and reasonable rules should be enacted by the Congress.

The recommendations of the Tax Executives Institute are as follows

**A. Fringe Benefits Which Should Not Be Taxed**

1. Fringe benefits which are currently excluded from income under specific provisions of law should continue to be exempt

2. Any fringe benefit which is basically a working condition should not constitute taxable income, e.g.

a. Office space, furniture, fixtures and similar items

b. Employer provided parking space

c. Chauffeur driven automobiles for executives or government officials to enable such individuals to work while traveling even if such traveling is between the employee's residence and his place of business

d. Free or subsidized transportation for employees where safety or availability is the primary factor

e. Supper money and transportation for overtime in an amount equal to the actual amount expended or a reasonable standard amount set by the employer

f. Availability of goods or services to the employee for testing and/or evaluation purposes

g. Subsidized cafeterias or restaurants

h. Security costs such as burglar alarms or the furnishing of bodyguards where the need for such items is reasonable under the circumstances

i. Travel agents' familiarization trips

j. De minimis gifts and periodic social functions such as picnics, Christmas parties, etc. (but substantial awards such as holiday trips should continue to be taxable)

3. *Employee Merchandise or Service Discounts*

These should not be taxable if available to a reasonably broad class of employees.

4. *Use of Employer Facilities Where Such Facilities Otherwise Have a Bona Fide Business Purpose*

a. Not taxable if available to a reasonably broad class of employees

b. If not available to a reasonably broad class of employees, not taxable unless the employer incurs measurable additional costs other than de minimis costs

**B. Measurement of Fringe Benefits for Inclusion in Income**

In the case of taxable fringe benefits, the measure should be the incremental cost incurred by the employer or other person supplying the benefit. De minimis additional costs should be disregarded. This recommendation is made for two reasons. First, as pointed out by Assistant Treasury Secretary, Donald Lubick, in his testimony on August 14, 1978, there is some concern as to whether any person would pay the so-called fair market value to obtain most fringe benefits. Second, by using a measure based upon incremental employer costs, the effect of fringe benefits on the tax system is neutral. That is, the employer will receive a deduction equal to the amount included in the employee's income as in the case of cash salary and wage payments.

**C. Other Recommendations**

Because of their nature and the difficulty in many cases of accumulating the necessary data, we believe that even where fringe benefits are taxable, they should not be subject to the withholding tax on wages but instead be subject to the requirements of information reporting, i.e. Forms W2 and 1099.

Furthermore, we believe that even where fringe benefits are subject to the income tax, they should not be subject to the Federal Insurance Contribution Act (FICA) and the Federal Unemployment Tax Act (FUTA). We make this latter recommendation because where fringe benefits affect highly salaried employees, such employees normally would have income in excess of the limit of contribution for the above taxes. With respect to lower paid employees, the additional complications and administrative work are considerable and would involve costs which are excessive in relation to the amount of additional tax involved.

For the same reasons, we feel that where meals and lodging are excluded from income under Sec. 119 of the Internal Revenue Code, such meals and lodging should be excluded from the provisions of FICA and FUTA.

Respectfully submitted,

s/ William J. Fait
President,
Tax Executives Institute

August 31, 1978

# Position Paper—Fringe Benefits

June 15, 1981

Dr. Norman B. Ture
Undersecretary Of Treasury
for Tax and Economic Affairs
Department of the Treasury
Room 3432
15th and Pennsylvania Avenue, N.W.
Washington, D.C. 20226

In re: Income Tax Regulations on Fringe Benefits

Dear Dr. Ture:

Tax Executives Institute, Inc. ("TEI") is an organization with approximately 3,800 individual members representing over 1,100 of the leading corporations in North America. Membership in TEI consists of persons employed by corporations who are charged with the administration of the tax affairs of their employers in an executive, administrative or managerial capacity.

In view of the discussion draft of proposed regulations on the taxation of fringe benefits released by the Treasury Department on 1981 January 15, Revenue Procedure 80-53 issued by the Internal Revenue Service on 1980 December 8 and the general interest in this area shown by Congress, Treasury and the Internal Revenue Service currently and over the past years, we have prepared the attached TEI position paper and ask that you consider it when proceding in this area.

While the January 15 discussion draft takes a reasonable approach concerning some issues, it clearly misses the mark of equity in others. The approach used in measuring the *amount* of taxable income created by a fringe benefit is especially disturbing. We feel that to completely ignore the incremental cost theory is to refuse to acknowledge economic reality, and disturb the symmetry of the Internal Revenue code.

Because the discussion draft was released by the previous Administration just as they were leaving office, we understand your staff is taking a fresh look at this area. Therefore, we will not attempt to comment on the specific points and examples contained therein; instead our recommendations are mainly general in scope.

. If TEI can be of assistance to you or your staff in this or any other area of mutual interest, please do not hesitate to ask.

Respectfully Submitted,

Tax Executives Institute

Matthew J. Kennedy
President

## TAX EXECUTIVES INSTITUTE

Position Statement on

## TAXATION OF FRINGE BENEFITS

### A. FRINGE BENEFITS WHICH SHOULD NOT BE TAXED

1. *Items which are presently excluded from gross income under specific provisions of law*
2. *Items which are basically a working condition, e.g.,*
   a. Office space, furniture, fixtures and similar items
   b. Automobiles for business usage
   c. Parking spaces for personal automobiles
   d. Chauffeur driven automobiles for business or government executives to enable them to work while traveling between business locations or their residence and their place of business.
   e. Items furnished for the safety or security of the employee and/or his family, if the threat of harm stems from the employee's position with or work requested by his employer, e.g.,
      i) transportation
      ii) security personnel
      iii) burglar alarms and other security systems
      iv) housing (in severe situations)
   f. Meals and transportation in an amount equal to the actual amount expended or a reasonable standard set by employer when requested to work in addition to normal working hours, e.g., after five, Saturday, etc.
   g. Meals when away from the city in which the employee maintains his principal office, even if the employee returns home that day and does not incur lodging expenses.
   h. Availability of goods or services to employees for testing and/or evaluation purposes if employee's position and expertise is appropriate considering what is being tested.
   i. Subsidized employee cafeterias or dining rooms.
   j. Use of employer provided gymnasiums or other facilities beneficial to the employee's health and welfare.
   k. Reduced rate or interest free loans.
   l. De minimus (cost of $100 or less) gifts and periodic social functions.
3. *Employee Merchandise or Service Discounts*
   These should not be taxable at all if made available to a reasonably broad class of employees and the amount charged by the employer covers his incremental costs.
4. *Incidental Employee Personal Use of Employer Owned Assets where Such Assets are Used Primarily for Bona Fide Business Purposes.*
   This should not be taxable unless the employer incurs measurable additional incremental costs other than de minimus costs. If the employer incurs more than de minimus costs, only the *additional incremental costs* should be taxable.

### B. MEASURING THE AMOUNT OF TAXABLE INCOME CREATED BY A FRINGE BENEFIT.

Where fringe benefits *are* taxable, the measure of taxable income should be the *additional incremental costs* incurred by the employer in providing the benefit. De minimus additional costs should be disregarded. This recommendation is made for two reasons. First, it is economically unrealistic to contend that an employee would pay the so-called fair market value to obtain these benefits.

Second, by using a measure based on the employer's incremental costs, the effect on the tax system is neutral, i.e., the amount that the employee is required to include in his taxable income is equal to the amount that the employer receives a deduction for, as in the case of cash salary and wage payments.

One of the best examples of both reasons is where a company airplane (assume a maximum seating of 10) makes a flight from one city to another for purely business purposes and one employee, knowing that only eight other employees are going, takes his wife. It is reasonably clear that the wife would not have paid the cost of a commercial ticket to make the trip and completely clear that the company incurred an insignificant amount of additional expense because of her using an otherwise unoccupied seat.

It should be made clear that the employer has the burden of proof in establishing the additional costs in such cases.

### C. REPORTING AND OTHER RECOMMENDATIONS

Because of their nature and the difficulty in most cases of quickly accumulating the necessary data, we believe that where fringe benefits are taxable, they should not be subject to withholding taxes on wages but, instead be subject only to the requirement of information reporting, i.e., Forms W-2. On the issue of reporting, we feel very strongly that such requirement should not begin until final regulations in this are are promulgated. We feel that the issuance of Revenue Procedure 80-53, requiring the reporting of fringe benefits on Form W-2 before it was decided what benefits represent taxable income, was ill-conceived. Instead of providing clarity in this area, this revenue procedure simplistically attempts to compel compliance with unknown rules through the threat of penalty. We consider the temporary remedy provided by IRS-80-133 to be inadequate and respectfully request that Revenue Procedure 80-53 be withdrawn in its entirety.

We believe that in no event should any fringe benefits be subject to FICA and/or FUTA taxes. Where fringe benefits effect highly paid employees, the employee is already over the limit of base contribution for these taxes. With respect to lower paid employees, the additional complications and administrative work are considerable and would involve employer costs which are excessive in relation to the amount of additional tax involved. For the same reasons, we feel that where meals and lodging are excluded from taxable income under Section 119, such meals and lodging should be excluded from the provision of FICA and FUTA.

# Statement on Fringe Benefits

November 1, 1982

The Honorable Roscoe L. Egger, Jr.
Commissioner of Internal Revenue
Room 3000
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Egger:

The purpose of this letter is to comment upon the report and recommendations of the New York State Bar Association's Tax Section on the tax treatment of fringe benefits ("the Report").

In your remarks at our 37th Annual Conference in Dallas last week, you reported that pending further congressional action on fringe benefits, the Internal Revenue Service would not be taking an active role in resolving the issue. Tax Executives Institute, Inc. (TEI) appreciates the candor with which you spoke and is fully aware of the constraints the Service is under with respect to the fringe benefits issue. Nevertheless, given the inevitability of action being taken on the issue and the attention already given to the Report, TEI believes it prudent to present our views at this time.

## Introductory Comments

TEI generally applauds the customary thoroughness and thoughtful efforts of the New York State Bar's Tax Section in this difficult field. The Report, which was prepared by the Tax Section's Committee on Employee Benefits, makes several valuable points and echoes in large part the proposals of other professional organizations interested in the benefits area. *See* Federal Tax Division of American Institute of Certified Public Accountants, "Fringe Benefits: A Proposal for the Future" (April 1979).

TEI wholeheartedly agrees with the Report that the primary goals of any system of taxing fringe benefits should be (1) the clear identification of the taxable benefit and (2) ease in determining the taxable amount of such benefit. The first of these goals can be accomplished only by unambiguous legislation, which is without question the province of Congress. The Report acknowledges that. (Pages 6-7.) As to the second goal, TEI strongly supports the basic criteria the Report proposes for developing a rational plan for taxing fringe benefits. The Report does a commendable job of detailing and explaining these criteria, which quite properly relate primarily to the *method* of measuring, reporting, and taxing fringe benefits. Thus, we consider it regrettable that the Report, in discussing the measurement and reporting of benefits, at many points strays beyond the standards it lays down—it ventures too often into judgments as to whether certain benefits ought to become taxable.

For example, TEI shares the Report's desire to maintain the integrity of our personal income tax system and to reduce the underreporting or nonreporting of income. We do not, however, subscribe to the theory, expressed on page 9 of the Report, that more taxpayers will cease to report items of income that are clearly stated to be taxable (such as dividends and interest) simply because Congress decides that certain fringe benefits should not be taxed because they are insubstantial and incapable of fair valuation.

To a certain extent, of course, the measurement and reporting questions are entwined with and dependent on the resolution of the policy issues. Hence, a discussion of measurement methodology remains to a large extent premature until Congress makes the necessary policy decisions. Stated simply, we must assume that taxable benefits have been fully delineated before we can proceed to implementing a reporting system for the taxable benefits.

## Measure of the Benefit

If the burden of reporting benefits is to fall squarely on the employers providing them, those employers must be given clear guidance as to the benefits to be included and the valuation of such benefits. Their obligation to report, the Supreme Court has clearly held, must be "precise and not speculative." *Central Illinois Public Service Co. v. United States*, 435 U.S. 21, 31, (1978). Employers should not be held hostage by vague formulations or by requirements that they perform subjective value judgments. On such a foundation of quicksand the fair administration of a system for taxing benefits will surely sink. Thus, the amount of taxable benefit must be as clearly and easily identifiable as the benefit itself.

The Report does an exceptional job of pointing out the pitfalls of applying the fair market valuation system to fringe benefits. (Pages 12-15.) It is clear that the fair market value standard only breeds controversy and as such is unacceptable if the employer is to be responsible for reporting such amounts. Accordingly, we agree with the Report's conclusion, as have many other commentators, that *cost* is the only fair basis upon which to determine the taxable amount of the benefit. The use of a cost basis is a major step toward the goal of providing uniformity and ease of determination of the taxable amount.

Having come this far, however, the Report takes a giant step backward by endorsing *allocated* rather than *incremental* cost as the measure of benefit. The first reason given for this choice is that allocated cost is less troublesome to determine. This is not necessarily true. From the timing point of view, the employer would be compelled to wait until the end of the accounting period to determine the portion of fixed costs to be allocated to the benefit. Increases in variable costs (incremental costs), in contrast, are more quickly and easily extractable. Indeed, incremental costs are already the basis for computing fringe benefits for SEC disclosure purposes. Regulation S-K, Item 402(a), Instruction 3D(i), 17 C.F.R. § 229.402(a). Paradoxically, the Report cites the fact that employers must already determine the costs of benefits for "various non-tax reporting and other business purposes" (page 18) as a justification for using the cost basis and then proceeds to discount a major non-tax reporting requirement that requires such benefits to be computed on an incremental basis. In effect, the Report would require employers to use *both* bases for determining cost, depending on the government agency receiviing the report. This result hardly comports with the stated goals of simplicity and reducing the employer's burdens.

The other reason for using allocated cost cited by the Report is that it "offers a far closer approximation to the value of the benefit conferred." (Page 19.) This conclusion is surprising, especially considering the length to which the Report goes to demonstrate (correctly) the wide variety of potential "values" for any one benefit. Furthermore, as already noted, the Report rightly rejects fair market value as the measure of the benefit, owing to questions concerning the various prices available for the benefit, the quality of the benefit, and the recipients' freedom of choice. Of what relevance, then, is the unsupported assertion that allocated cost more closely approximates that discarded, amorphous standard?

TEI believes that the incremental cost standard proposed by the AICPA in its 1979 proposal is a far more justifiable standard because of its ease of application, as well as its compatability with other management reporting requirements. The Report acknowledges this, at least to a limited extent, for it would exclude a benefit from taxation when the *incremental* cost of providing the benefit is minimal. (Pages 20-21.) Once that threshold has been crossed, however, the Report would have the employer revert to *allocable* cost in reporting the amount of a benefit. Thus, even in reporting a single benefit, the employer would be required to use both cost systems. If the objective is truly to reduce the reporting burden, use of incremental cost for determining both the taxability and the taxable amount of the benefit would be far more logical.

We note in this connection one of the Report's digressions into policy judgment. At pages 20-21 of the Report, it is suggested that the *de minimis* exception should apply only where the benefits are not limited to highly compensated employees. If Congress determines that a benefit is non-taxable because the cost of providing it is minimal, however, the nature of the class of the recipient does not alter that reasoning. That is to say, the cost is no greater if the benefits are made available only to highly compensated employees. Rather than report all benefits that exceed a certain incremental cost threshold, the Report would apparently require that the employer exercise its subjective judgment as to whether or not these *de minimis* benefits are discriminatory in some manner. The Report thus undercuts one of the principal goals of its proposal—implementation of a reporting system that is precise and easy to administer.

### Penalties

In addition, the Report compounds the employer's burden by proposing the imposition of civil penalties in the event of nonreporting or underreporting of taxable fringe benefits. (Pages 21-26.) It perceives a need for "effective inducement" of employers to report the full amount of benefits. Just why employers would need further inducement to comply with requirements established by law is never explained and is especially difficult to comprehend in light of the changes made by ERTA and TEFRA (the latter of which, of course, was enacted after the Report was prepared). Quite simply, we fail to see why the failure to adequately report fringe benefits should require treatment different from that concerning other benefits. The reporting requirements of section 6052 and penalty prescribed in section 6652(a)(2) have to date been considered adequate safeguards for the reporting of group term life insurance. Would it not be simpler to expand those sections to specifically include the reporting of other taxable fringe benefits? The Report intimates that employers are criminals looking for any means to evade the law. This view cannot be substantiated and is clearly contradicted by experience in other reporting areas.

### Information Reporting

With respect to the physical reporting aspects of fringe benefits taxation, the analogy to group-term life insurance is equally applicable. There is no reason why the employer should not be given the option of reporting the amount of taxable benefits either on the same Form W-2 that wages are reported on, the Form W-2 on which taxable group-term life insurance benefits are reported, or even on a completely separate Form W-2. The current provision allowing a separate report for insurance benefits recognizes that Forms W-2 are normally prepared through an employer's payroll system that is not normally concerned with or capable of handling irregular or non-cash benefits. The modification of payroll systems to include reporting of fringe benefits could prove unnecessarily costly as compared with the expansion of an existing ancillary system for reporting group-term life insurance benefits. There is no more risk that taxable fringe benefits will go unreported under such a system than there currently is as to section 79 benefits and Congress and the Service have not as yet considered that system to be in need of reform. Once again, the Report's recommendations belie (perhaps unintentionally) its stated goal of minimizing the employer's administrative burdens. Indeed, the Report's suggestion that the time requirements for furnishing Forms W-2 to employees be extended itself argues in favor of allowing fringe benefits to be reported separately.

### Withholding

TEI endorses the Report's recommendation against requiring withholding on taxable fringe benefits. (Page 25.) The timing and computation problems associated with withholding would be especially acute in this area. We must point out, however, that the Report's curious tendency to inject social judgments into the administrative aspects of fringe benefits taxation once again emerges to contradict its laudable opposition to withholding. The statement that dispensing with withholding would be more practical if the benefits valued at cost were limited in nature and amount with the excess taxed at market value and subject to withholding (page 28) is not only wholly immaterial to the point under discussion but runs directly contrary to the Report's prior reasoning on cost valuation and administrative simplicity. Is it reasonable to burden the employer not only with the task of valuing the same benefit at incremental cost, allocable cost, and now, at fair market value (which the Report ably demonstrates to be extremely difficult to ascertain), but in addition, to require withholding on that market value?

TEI agrees with the Report's recommendation that an employee should be permitted to demonstrate that the value to him of a particular fringe benefit is lower than the cost value reported by the employer. (Page 30.) We see no reason, however, to impose a burden of proof on the employee any greater than that customary in reporting income in the form of property. The Report's proposals that a lower value be demonstrated by a clear preponderance of the evidence (page 31) may well discriminate against recipients of taxable fringe benefits.

### Conclusion

In summary, TEI agrees with the Report's objectives of precise identification of taxable benefits and ease in determining the taxable amount of such benefits. Unfortunately, the Report itself frequently loses sight of those goals. Indeed, the goals are almost buried beneath the burdens of determining (1) whether a benefit is "incidental to the employer's business"; (2) whether the *incremental* cost of the benefit is "minimal"; (3) what the *allocable* cost of the benefit is; (4) whether the value of an employee's benefits exceeds a stated annual minimum; (5) if so, what the *"fair market value"* of the benefit is; and (6) what the amount withheld should be. The guiding light of precision required by *Central Illinois Public Service Co. v. United States* is lost in the maze.

TEI subscribes to the Report's announced goals of designing a reporting system for taxable fringe benefits that would limit the employer's responsibility to determining that a particular benefit is taxable (in accordance with precise and not speculative guidelines) and his cost in furnishing the benefit. Those determinations, however, should not require value judgments by the employer or the valuation of the benefit under two or three different methods. Under such circumstances, the administrative burdens and additional costs imposed by the employer under the system proposed in the Report would totally offset any revenue benefit to be gained.

TEI would be pleased to meet with you and your staff in an effort to resolve this difficult issue.

Respectfully submitted,
TAX EXECUTIVES INSTITUTE, INC.

s/Sol Coffino
President

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July 21, 1983

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Mr. John Salmon
Chief Counsel
House Ways and Means Committee
Room 1102
Longworth House Office Building
Washington, DC 20515

RE: Fringe Benefit Legislation, H.R. 3525

Dear Mr. Salmon:

I had a long conversation yesterday afternoon with Jayne Boyle of your staff about the possibility of my testifying before the Subcommittee on Select Revenue Measures on August 1. I am not sure yet whether that will be convenient for me, but I will be in touch with Jayne regarding that probably early next week.

I was invited to testify before the Finance Committee on the fringe benefit issue during its hearings last month. I have enclosed a copy of my written statement for your information. As you will see, the position that I am taking is in favor of taxing all fringe benefits, including those currently excludable under various provisions of the Code. I have completed a scholarly article about my theory of inclusion and the mechanism I propose therefor, which I will be happy to send along as soon as I can.

Jayne also asked me to comment specifically on the proposed legislation in addition to providing the generalized statement that I made before the Finance Committee. Although I have not yet written up a formal statement, my initial thoughts on the subject are also enclosed.

Should you wish to talk with me about this issue, please call me at (213) 825-4840.

Very truly yours,

Karla W. Simon

Karla W. Simon
Visiting Professor of Law

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# TESTIMONY
# BEFORE THE FINANCE COMMITTEE
# OF THE UNITED STATES SENATE
# HEARINGS JUNE 22, 1983
# ON THE STATUS OF FRINGE BENEFITS
# UNDER THE INTERNAL REVENUE CODE OF 1954

* * *

Written Statement of:

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# FRINGE BENEFIT TESTIMONY©

Karla W. Simon

## Introduction - Definition of Terms

Defining the term "fringe benefit" for purposes of approaching the subject matter to be addressed in my written statement proved to be a difficult task. The choice of a broad and as widely comprehensive definition as possible was made in order to simplify the point of departure. Thus all benefits, facilities or services furnished by employers to employees beyond the bare minimum required for adequate performance of services will be considered to be fringe benefits. Given that scope, the term includes such items as carpet on the floors, pictures on the walls and a receptionist to answer the phone. It also includes far more significant items currently excluded from income under various provisions of the Internal Revenue Code such as employer-funded health insurance and deferred compensation plans. My testimony will consider all forms of fringe benefits—from pictures to pensions—and will propose a mechanism for taxing them, or not taxing them, as the case may be, in one simple system that may be applied to them all.

At the outset, however, it is well to recognize that certain fringe benefits coming within the broad scope of the definition given above are properly excluded from the tax base. The reason is that some items are more properly characterized as "conditions of employment" than as taxable items of compensation. It has been long accepted that items which come within the "working condition" definition are nontaxable though an exact definition of the term is difficult to achieve. The fact that the employer furnishes them simply to provide a better working

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environment for the employees (an essentially noncompensatory reason) certainly does not remove from them the compensatory value to an employee who might otherwise exist without carpet or pictures, do the work herself or pay for it herself. Yet to suggest that ordinary office furnishings, as opposed to certain relatively extraordinary ones which might well constitute a different matter, ought to be included in income would be similar to suggesting that the psychic income derived from enjoying a job ought to be included in a person's income for tax purposes. Aside from the fact that the idea of including psychic income has been mentioned by well-respected commentators (e.g. Henry Simons) the measurement difficulties with regard thereto are obviously extraordinary.

Valuation may well be the most significant factor in the general determination that so-called working conditions should not result in income taxable to employees. It is a significant factor with respect to all other fringe benefits as well. But valuation difficulties should not in most circumstances be the major determinant of taxability or nontaxability. For example, going beyond necessary working conditions into the realm of private secretaries and free parking privileges, one might find that the valuation difficulties, although great, may not be sufficient to outweigh the inclusion of the items in the taxable base in many cases. Thus it becomes necessary to attempt to create a system of taxation which is not dependent on individual perceptions of worth and which succeeds in taxing to employees those benefits that are compensatory, that are reasonably easy of valuation and that should, from a a policy standpoint be includable in the tax base.

It might well be said, in response to the last statement, that we currently have such a system, that the Internal Revenue Code as written makes the proper distinctions and that we ought to stick with that. There are serious problems with that response. First of all, from an historical standpoint, it is clear that Congress has displayed a great reluctance to deal with the question of fringe benefits in any systematic manner that would attempt to establish a general policy.

The second difficulty is that current debates about possible changes in our system of taxation have tended not to focus on the issue of fringe benefits, but it is indeed a pervasive problem. For example, with respect to the scholarly discussions regarding consumption or cash-flow type taxes versus income taxes, it is readily apparent that the question of which fringes to tax and which to exclude under a consumption tax system has the same parameters as in an income tax system. Nevertheless, there has been little mention of this specific issue in the generalized debates about the propriety of the two systems.

Turning to the flat rate tax or a tax with broader brackets, the issue of whether or not to include fringes in the base is one of obvious importance but it has thus far been infrequently mentioned in the lay literature expounding the virtues of such a tax. Looking at the equity-efficiency debate, on the other hand, one notes a marked lack of attention to this issue. In point of fact, there is no need to determine whether one is in the camp of reformers who favor equity or that of those who favor efficiency--wholesale exclusion of fringe benefits from the tax base is both inequitable and inefficient.

It is also irrelevant whether one views a shift toward labor income as the major source of revenue-raising efforts as proper, if indeed one perceives that such a shift is occurring. Nor is it particularly important whether one views progressivity as vital to fair system of taxation. If labor income is going to be taxed at all it seems perfectly proper to say that all labor income should be included in the base, and that it does not matter what rates are applied to that base.

The proposal I am making today is neutral with respect to all these issues. Thus my testimony will attempt to inform these general debates about tax reform with a sense of the magnitude of the problem created by nontaxation of fringe benefits, and it will suggest a vehicle for taxing fringes under the current system of income taxation that should serve as a model for other systems that we may well move to in the future.

In addition to the lack of systematic attention to fringe benefits by Congress and the failure to consider those items in general reform proposals, the scrutiny which this topic deserves seems to increase as time goes by. In recent years a number of new fringe benefits have, for various reasons, been excluded from the tax base. In addition, the Congress has strongly resisted attempts by the Treasury to tax systematically certain other employee benefits. And the importance of fringe benefits as a percentage of total compensation has grown markedly.

Finally, a note about simplicity. While it is clear that simplification of the tax system is a desirable goal, it is also clear that taxing fringe benefits of necessity involves the addition of some complexity to the current tax system. Using the mechanism provided by

§83, as suggested here, to establish a method for taxing fringes in no way reduces that added measure of complexity, since the reasons for the complexity are more factual (i.e. related to valuation) than legal. Nevertheless, the thesis of my testimony is that a reassessment of the structure of the law as it currently relates to fringe benefits will be a vehicle for reducing complexity as time goes on. The initial debate should provide both the framework for the system of taxation as well as a methodology for assessing future changes in the scope of fringe benefits made subject to tax.

### A. General Features of the Current Taxation of Fringe Benefits

There are a few well-known methods of demonstrating the distortions caused by the nontaxation of some compensatory fringe benefits and the importance of these issues for our society. The first is to compare the treatment from an equity standpoint of a person (A) who receives a certain portion of her compensation in cash and the other portion in a selected number of fringes (e.g. child care, health insurance, employer-supplied recreational facilities) and a person (B) who is paid entirely in cash and who must purchase those items out of after-tax income in the open market. The actual amount of disposable income after purchase of the above-mentioned items in B's case stands in stark contrast with A's situation. The perceived inequity can presumably be remedied by requiring that A pay tax on the items now received tax-free from her employer.

Secondly, it seems that the difficulties presented by horizontal inequity in the tax system resulting from the existence of untaxed fringe benefits are compounded by a different sort of inequity, the vertical inequity as between groups of taxpayers who receive fringes but who are in different tax brackets. Taxpayers thus benefit from untaxed fringes to the extent that they are not taxed in differing amounts which depend solely on the amount of income they earn which is subject to tax. Like horizontal inequity, the existence of this disparity in amount of benefit derived seems clear and is demonstrated elsewhere.

Another important factor in pointing out the problems created by nontaxation of certain fringes is the public sensitivity to the inequities they create. Although the extent to which the public perceives that the tax system is unfair as a result of the tax treatment of various fringes has never been systematically analyzed, it is fair to say that such a perception exists. As a result, it seems apparent that the social cost of continuing to allow broad exclusions for certain types of highly visible benefits may well be too great to continue their existence. It is certainly difficult to document the point at which the sense of the unfairness of the tax system becomes sufficient to cause a person to overcome scruples and fears about cheating, but that point obviously exists for some otherwise law-abiding citizens. To suggest that as a result perceptions of unfairness represent the single most important problem with the current tax system is probably not an overstatement. Thus the issue of which fringe benefits should and which should not be taxed to undo either horizontal inequity or vertical inequity or both must be viewed in that context.

The final method used to demonstrate the "problem" is to simply point to the statistics which show the magnitude of the "tax expenditure" involved in the exclusion of each fringe benefit on an annual basis. The figures may well be said to be staggering, but the fact that a certain amount of revenue is foregone as a result of the various exclusions does no more than state the obvious. The major issues suggested by the statistics are whether the failure to tax certain fringe benefits is so inequitable on a broad-scale basis as to be unworthy of continuation and whether the exclusions are an inefficient way of going about doing something that probably is worth doing, but perhaps not in the same fashion or to the same extent. These two considerations also illustrate the concern about the allocative inefficiency of fringe benefit exclusions. Thus there is inequity as between groups of employees in industries for which the provision of certain fringes is either easy or fairly inexpensive and employers in industries which do not have that capacity. It seems fairly apparent that a change from the current progressive tax system to a flat rate system without some attempt to require the inclusion in the income base of a number of fringes would put even more pressure on the labor market and would tend to shift people into those jobs that provide the best untaxed fringes. It might well be that as a result there would be development of the capacity to provide more nontaxable benefits in those sectors of the economy which had theretofore not been seen as providers of a significant amount of fringes, but the evening-out period might prove to be dislocative for many people. The current trend in compensation is toward more and more fringes, and as a result, allocative inefficiency may be expected to increase.

## B. Application of Section 83 to Fringe Benefits

It is my proposal that § 83 be used as the mechanism for taxing fringe benefits to employees. This suggests a comprehensive approach to all fringe benefits but raises a few not insignificant problems. Apart from the difficulty created by the current definition of "property" found in the regulation at § 1.83 - 3(e), the problems are essentially those present with respect to other property transfers prior to the enactment of § 83 -- timing and amount of inclusion. Assuming for purposes of discussion that the use of § 83 represents a sensible policy decision regarding fringe benefit taxation (the analysis of which is found in Part C), there are essentially three examples which are important to look at to see how the change will affect certain fringe benefit types. The first of these is relatively straight-forward in that it involves a transfer of trangible property whereas the second two are less so in that they may involve no outright transfer of property in the narrow sense.

### Example 1. Employee Bargain Purchase of Refrigerator

In January, 1983, Elmer begins working for Icy Refrigeration which manufactures refrigerators in Smalltown. Icy has a policy whereby all employees may purchase refrigerators at cost plus 10% for the less expensive models and cost plus 25% for the more expensive models. The only restrictions on this policy are that it is available only to current employees who may not purchase more than two refrigerators a year. In January, 1984, Elmer is married and purchases for his new home one of the "more expensive models" for $400. Such refrigerators ordinarily sell in the furniture store in his town for $700 and in discount stores in Big City (200 miles away) for $600.

Applying §83 to these facts, it is clear that the proper timing of the taxable event is not when the unfunded and unsecured promise to pay in the future is made (i.e. when the employment relationship between Elmer and the employer begins) but rather when Elmer exercises his rights under the promise and purchases the refrigerator in 1984. Although there is some clear benefit for Elmer arising from the mere promise that he may purchase the item, there is no basis for measuring the benefit until he actually does.

This result may be accomplished under the statute by permitting the deferral of the taxable event until there is no longer a substantial risk of forfeiture. Such a risk exists in this instance because the option to purchase at a discount is available only to current employees, and there is a possibility up until the time of purchase that Elmer will be fired. Although that possibility may well be illusory in any given instance, the condition that a person be a current employee is a real one, and the deferral of the taxable event until the time the purchase is made seems appropriate.

Another way of looking at §83's application to these facts would be to focus on §83(e)(1) which states that the section "shall not apply to . . . the transfer of an option without a readily ascertainable fair market value." If that subsection is used to take the transaction out of §83 until purchase, the proper result of deferral until purchase of the discounted item is easily accomplished.

The deferral result is appropriate for reasons of sound tax policy. Not only does deferring taxation until the bargain purchase occurs eliminate the extraordinary difficulty of determining the fair market value of the promise by preferring a solution that provides a little more certainty as to the amount includable (although not complete certainty, as demonstrated below), but it is also important to defer because of the administrative difficulties that arise when items are taxed and it is not clear from the legal or factual circumstances that they ought to be includable in an individual's income. Under the judicially developed doctrine of claim of right, a taxpayer is required to include an item only when she has clear, unfettered title to the item, and under the facts here that is not the case until the bargain purchase is made. Any other rule would result in confusion as to timing of income in cases where the right thereto is not firmly established and to numerous instances in which an amended return making a claim for refund would be necessary. Such a result would not comport well with the system of annual accounting. Therefore, Elmer's taxable event under § 83 would occur when he buys the refrigerator in 1984. In addition, there would be no inclusion in his income of any amount in 1983 or in 1984 as a result of his ability to buy additional refrigerators under the Icy employee discount plan.

As stated above, the taxable event is thus deferred until a time when it is easier to value the amount includable, but as the facts of this example make clear, all of the valuation hurdles are not overcome by the deferral. Here we have a situation which comports with reality as we know it, a situation in which the item is sold in different markets. Thus there is considerable difficulty in deciding what the fair market value is for the plain and simple fact that we don't know what the market is. The difficulty here described would be most easily, and most fairly, dealt with by promulgating regulations that say that the amount includable under such circumstances would be the difference between the amount paid and the lowest retail price at which the item is sold in a 100-mile radius of the individual's residence. Thus the amount includable to Elmer in 1984 is $400, and the fact that a smaller amount would have been includable had he lived closer to Big City is irrelevant. Because it is arbitrary, such a rule raises some obvious inequities, but does seem manageable administratively.

It is important to note that although this example deals with a manufacturer, the rule would be the same if the employer were a retailer. Thus in neither of those circumstances, with respect to tangible items, does the employer's cost determine the includable amount. The amount is determined with reference to the general market, not the market in which the taxpayer buys.

Under §83, if Elmer were to have his employer transfer a refrigerator to one of his friends or family members, the general rule would apply to tax him on the spread between amount paid and fair market value of the refrigerator at the time that person bought the refrigerator at discount. Should Elmer dispose of the right to exercise his employee discount to someone else for cash, the rationale that §83 does not apply to transfers of options without a readily ascertainable fair market value would suggest that the rules for taxing as ordinary income amounts received on pre-vesting transfers would not come into play. Thus Elmer would pay tax on the amount received from the purchaser but would defer being taxed on additional income until the purchaser of the right bought a refrigerator. It is unclear that that is the correct result.

The alternative would be to say that the section does apply and that the amount received by Elmer from the purchaser would be ordinary income. In that event, the purchaser of the right would not have to recognize the income inherent in the bargain purchase at the time the purchase were made, and Elmer would not have any additional compensation income. Presumably this result makes sense because a major reason for not including the value of the right in income when it is initially received is the difficulty of determining that value. A sale at arm's length eliminates that rationale and puts a dollar value on the amount of compensation received. Although this solution may be difficult to reconcile with §83(e)(1), it seems to work better than having to struggle with two-step income inclusion.

Example 2. Airline Employee Discounts

Sammy Steward is an employee of Inter-American Airways. He lives in Los Angeles, but the flights he works are based in San Francisco. Inter-America makes available to him the opportunity to fly free on any of its flights in the continental United States and for half-fare on any flights to Central or South America. His spouse and any dependents are also able to fly on any of these flights for half-fare. With respect to the free flights, Sammy may use this benefit only on a space-available basis, but the other flights are available by reservation. In addition to these fringe benefits, Inter-America pays for Sammy's flights to and from Los Angeles so that he will be in San Francisco at the appropriate time for his scheduled working flights.

Assuming that the definitional hurdle can be overcome (i.e. that exercise of the right to use the employer's services below cost constitutes an item of property), the application of §83 to these facts is relatively easy. As in Example 1, it seems clear that the proper time for the taxable event for Sammy is not when he is promised that he may fly to New York for free, but rather when he does so. The same is obviously true of half-fare flights for him and his family to Mexico City. Thus the results are the same under §83 whether the fringe benefit is a tangible item manufactured or sold by the employer or a service furnished by the employer. If these items are made available to the employee at a price which is below the price he would pay in the marketplace, the amount to be included in the income of the employee is the difference between the amount paid and the fair market value.

Although there is some difference between these two benefits and the furnishing of transportation between Los Angeles and San Francisco, it seems apparent that the same result ought to follow for those trips. The travel in question is essentially commuting, a personal and nondeductible expense for all employees, no matter how long the commute may be. Thus having the employer pay for this expense must result in income to the employee with no corresponding deduction for the employee. To hold otherwise would put Steward, an airline employee, in different circumstances from a railroad employee named Flowers, and that hardly seems appropriate.

The amount includable under §83 is the fair market value of the airfare. With respect to the space available trips, the amount would presumably be figured on the standby fare, whereas with the half-price and commuting trips the amount includable should be the difference between what is actually paid and the lowest available coach fare.x Although there are some obvious difficulties in valuation present here as in Example 1 where the items that are received are discounted in some markets, that should not create a significant inequity problem except with respect to certain individual cases. Again, it seems clear that those should not outweigh the necessity of setting a reasonably easily administrative rule.

### Example 3. Payment of Insurance Premiums by Employer

Edna Explorer is employed by Lost Ark Expeditions. Her job entails many hazardous trips to exotic lands. In order to provide for her safety and comfort in carrying out her duties, Lost Ark pays premiums on accident and health insurance for Edna. The only carrier that will write such insurance is Lloyd's of London, and the premiums are $3000 annually, payable January 1, of each year. Edna has an absolute vested right to the insurance under this policy. Should she leave Lost Ark's employ, a refund will be paid to the company.

Applying §83 to these facts, it is obvious that the first matter to be confronted is whether there has been a "transfer" of "property" by virtue of the payment of the premium. Although there are some technical difficulties with applying the language of the statute to these facts, they should not be insurmountable. The statute could be interpreted to cover this situation simply because there is the conferring of an immediate benefit, rising in fact to the level of a property right, that accrues to Edna when an insurance policy is purchased in her name by Lost Ark. Obviously the result would be easier if there were an actual physical transfer of the policy to Edna, but to require that in order to apply §83 seems excessively formalistic. Applying §83 to these facts has the same result as applying constructive receipt principles, so it is clearly not a radical result.

The second question is whether there is a substantial risk of forfeiture in the terms of the insurance contract which should defer vesting. The answer is that the refund clause does not constitute such a risk. Her coverage is conditional on her employment (the rendering of substantial future services per §83(c)(1)), but for the period of her employment she is fully covered, and the cost of that coverage on an annual basis is $3000. Should she quit and an amount be refunded to Lost Ark, she would have a lesser amount included or, if the events were to span more than one taxable year, she would have a claim for refund. Claim of right principles suggest the identical result.

The real problem arises when it comes to figuring out what is the fair market value of the item to be included. The difficulties that are present in the example here are inherent in all situations in which an intangible fringe benefit is purchased by the employer and then made available to the employee. It will be true in any number of cases that the employer will be able to take advantage of certain economies of scale in the purchase of the items in question. That is ordinarily true with respect to group insurance plans where the employer pays the premiums. The fact that there are economies or that there might be special circumstances which increase the price paid by the employer as suggested by the case of Edna and Lost Ark must have some bearing on the amount that is included in the employee's income under §83. But the existence of an employer's purchase should not suggest that in all cases the includable amount of a fringe should be the employer's cost.

In the first example, which deals with a manufactured, tangible item, equity seemed to demand that the includable amount be measured by the general market price of the item. What about here? When it comes to large group insurance plans there is no reason to assume that the market is not large enough to have the employer's cost actually represent the proper measure of includable income. In other words, the standard should be that employer's cost will be used as a rule of convenience for purchased intangible items where the number or amount of items purchased is adequate to establish a market.

Using such a test of valuation in these circumstances has some deficiencies, largely because it is hard to determine the boundaries. If we look back at Lost Ark, and try to determine what the includable amount should be for its six-person office staff for whom the premiums it pays amount to $50 per person per month, the problem of the test enunciated above stands out with some clarity. It seems that regulations could deal with this type of situation by simply setting out the general test stated above and then by saying that in all other circumstances the result is a facts and circumstances one.

How does that effect Edna? Presumably under the test just stated, her includable income from the purchase of the insurance should be $3000 if that is the amount that anyone would have to pay for this insurance. If the amount paid by Lost Ark is greater than the amount anyone else would have paid simply because of Lloyd's experience with that company, the amount includable by Edna should also be $3000. Under such circumstances it might be better economically for both Lost Ark and Edna if Lost Ark were to pay her the cash and have her purchase the insurance herself, a suggestion they might or might not be willing to follow.

There are then issues of valuation raised by Edna's lack of choice in the matter. Despite textbook discussions of these matters, the proper amount to be included should not be affected by compulsion. After all, this was presumably part of the job description, and if Edna wanted the job but didn't want to bear the cost of the tax on the insurance herself, she presumably could have bargained for more salary to ease the pain.

The rule developed in this example is one from which a general rule, applicable to all funded promises to pay in the future, can be extrapolated. The taxable event is the funding of the promise, either by paying for an item such as an insurance policy, an annuity or a parking permit or by self-funding the promise by contributing on an employee's behalf to a fund set aside for her which will pay benefits in the future. Thus a person will pay tax on the benefit received from having the fund made available even though she may never make use of it (e.g. never be sick). The foregoing logic would suggest that there be the same result when the funded promise to pay in the future is a retirement plan. There is no good reason why furnishing retirement security by purchasing an annuity should be taxed currently when contributions to "qualified" deferred compensation plans are not.

These three examples cover a range of various possibilities for taxing fringes under §83. The first and second ones deal with unfunded promises to pay and opt for inclusion when there is an actualization of the benefit received by the employee. The third recognizes that when there is a financial outlay by the employer on behalf of the employee which is nonforfeitable, the time for the inclusion is when the expenditure which gives rise to the benefit occurs. With respect to the question of valuation, the general rule of §83 would ordinarily apply and the market would be the market in which the general public purchases the item in question. In some circumstances when the fringe is an intangible benefit purchased by the employer a rule of convenience is espoused which would use employer's cost when it seems properly, from an objective standpoint, to accord with market valuation.

These three examples do not, however, deal with the need to distinguish taxable fringe benefits and nontaxable working conditions. Nor do they consider the possibility of the need for a de minimis rule. Those issues and others regarding the policy aspects of this proposal will be developed in Part C.

## Part C. Policy Analysis

Given the total lack of systematic thought involved in the development of the current scheme of nontaxation of fringe benefits, the next question is what fringes ought to be subjected to the new regime of taxing them under §83. As was stated at the outset, the main point of this testimony is that all fringes should be taxed to employees under §83 unless there is some weighty policy or administrative convenience reason for exempting them. I will now explore that idea and propose some factors that should be taken into account in defining the categories that are taxable and those that are not.

## Possible Exclusions

### 1. Working Conditions

First of all, it is appropriate to accept the generally recognized position that working conditions are nontaxable and that §83 should not be interpreted to to include such items in income. But there is little agreement as to what that term means. Thus some discussion is in order to arrive at a definition of working condition that is generally acceptable and results in only the proper items being excluded from the tax base. The definition of working condition used by the Service in the 1981 draft of Proposed Regulations, "any item furnished by the employer either to enable or to facilitate the performance of employment services by the employee," is a useful and thoughtful one. But analyzing the matter further with reference to a specific example, one wonders why the Service did not exclude free parking from income under the working condition portion of the regulations rather than the administrative convenience portion of the regulations.

Upon reflection it seems obvious that with respect to most working conditions administrative convenience is significant factor in their nontaxability. For example, it would be hard to allocate a per employee cost of luxurious carpeting in the executive suite, since presumably secretaries and assistants enjoy the feel under their feet as much, if not more so, than the executives do. But is the fact that the president of a company has drapes in her office whereas the workers in the plant must make do with venetian blinds, the kind of thing that should be taken into account in determining that an item ought to be taxable? In other words, is the difficulty of valuation the only factor to be given heed?

Surely not, yet we are then left with the need to set up some objective standard for defining nontaxable working conditions as the Service has tried to do in the 1981 Draft regulations. Having accepted valuation as an important part of the definition, what about other criteria? Nondiscrimination should clearly be a factor in making a decision whether or not to tax certain benefits (indeed, it should be a feature of any de minimis rule), but here, where some discrimination should be allowed, the test for exclusion must be different. As a method of dealing with discriminatory conditions in establishing an appropriate test for defining excludable working conditions, one can look to the business expense area for guidance in making the judgment as to what should be includable and what should not. The definition given by the Service in the regulations is surely appropriate, but one might also wish to add the phrase "other than items which are lavish or extravagant under the circumstances." Thus the executive or the movie star who is provided with a car and driver by her employer would not be taxable on the value of those services while she is going from place to place when she is working even though her secretary does not receive the same benefit. This rule would not, however, exclude the fair market value of commuting in that same vehicle.

The administrative convenience as a result of valuation difficulties is important, and discrimination among employees is less so. However, the major rationale for seeking to exclude working conditions from income is that they are generally provided by the employer principally for a noncompensatory reason. Although that does not make it any easier to draw the line, it seems that the regulations under §83 which would prescribe rules for excluding working conditions ought to make mention of that fact specifically. Thus the rule proposed by the Service and quoted above would also have language added to it stating that working conditions are furnished for noncompensatory reasons.

So what about free parking excepted by the Service under the 1981 Proposed Regulation? If one begins with the assumption that the employer's paying for personal, nondeductible expenses on the employee's behalf ought to constitute income to the employee, one ends with the idea that free parking ought to be included in income. This is simply an extension of the idea that personal use of a car to and from work is taxable and that the trips between Los Angeles and San Francisco in Example 2 in Part B. above are also taxable. It is pointless to come up with examples of employers in the country who have vacant lots adjacent to their plants where they let employees park as a good reason for excluding free parking in Los Angeles (where it may cost as much as $200 per month) from income. Those employees who use the vacant lot would presumably have no income anyway since the fair market value of the parking is at or near zero.

2. De Minimis Rule

The parking question raises, of course, the second exclusion from the general rule. Should there be a de minimis rule for fringes which, unlike working conditions, are only indirectly related to job performance? Surely there should and one of the principal components should be that the excludable items are made available to all employees on a nondiscriminatory basis. An example of a situation in which a de minimis rule could be used would be with respect to employer-provided recreation facilities. It might make sense to tax an employee on the fair market value of the use of lockers, showers, the track and a weight room simply because the employee could buy access to such facilities for $300 a year if she were to do so out of her own pocket. But suppose she didn't have access to any comparable facilities because there weren't any in the immediate vicinity? This type of item, which clearly has a value (unlike free parking on vacant lots), is difficult to allocate on a per employee basis. In addition, the circumstances of the use might dictate different values for different employees. Thus it seems that certain repetitive items such as this available on a nondiscriminatory basis to all employees could be excludable because their value is frequently mimimal.

### Impermissible Exclusions

#### 1. Administrative Convenience

There is then the question of whether there are any items in addition to working conditions and minimal fringes that ought to be excluded simply for reasons of administrative convenience because of the difficulty of valuation. Under the two rules proposed here, it does not seem that a separate administrative convenience test is necessary. One of the prime candidates for such a test is employee discounts on the purchase of employer products. Although the Service has proposed such an exclusion in the 1981 Proposed Regulations, the principal problem with that analysis is that the rule requires valuation anyway, so it seems that if valuation is required there is no good basis for the exclusion. In addition, as Example 1 in Part B makes clear, valuation is not that difficult anyway.

### 2. Other

Finally, one must consider the question of the propriety of changing the current scheme of taxation so radically at a time when certain fringes have become a way of life, so to speak. That seems hardly persuasive as a rationale for continuing current exclusions both because the possibility of grandfathering here would produce unlimited complexity in what is essentially a simple proposal and because such an approach to change seems very inappropriate. It is particularly inappropriate when one takes into account the fact that there is now movement toward a broad-based tax, and the considerations expressed here are those that motivate those proposals also.

### Propriety of the General Rule

My statement today suggests that fringe benefits of all sorts should be included in income under §83 of the Code. The proposal thus has two essential parts: 1) that the amount includable in income should be the fair market value of the fringe benefit, and 2) that the proper time for taxing the item is when the benefit actually occurs.

The conclusion that fair market value is the proper measure of the amount of income is based on the assumptions that the only reason for making a payment that we characterize as a fringe benefit is a compensatory one and that the amount of the fringe benefit reduces or should reduce the actual cash compensation paid to the employee in an amount equal or nearly equal to the value of the fringe. The amount of the reduction of the cash compensation will not always be precisely equal to the fair market value of the fringe partially because the actual value of the fringe to any given employee may be difficult to determine. In addition, there may be a wide difference between employer cost and employee value and it is not clear how the saving by the employer is shared. Nevertheless, there is some rough parity between the reduction in cash compensation and the fringe's value, and the decision as to what the makeup of a compensation package will be is dictated by the awareness of this fact on the part of both the employee and the employer.

Currently this bargaining between the employer and the employee is skewed because there is an additional factor taken into account in the process, the nontaxability of fringes. That makes them far more valuable to the recipient employee than cash income and may thus encourage the employee to opt for items which are nontaxable simply because they are. This result tends to be inefficient both for the individual employee and for the economy as a whole, since it tends to encourage inefficient choices in all compensation decisions that are bargained in any significant way.

The proposal that is made here would be tax neutral as to cash or kind compensation on the employee's side of the matter. With respect to the employer's side, the principal disadvantage of using a §83 rule to tax fringe benefits (aside from the obvious valuation and allocation difficulties) would come with respect to deferral of deductions under §83(h) when inclusion is deferred because an item is subject to a substantial risk of forfeiture. Although this result might not be desired by employers, it could have certain beneficial effects in that it would encourage permitting vesting if the deductibility of an item is an important feature of the employer's willingness to make it a part of the compensation package. In this way symmetry as between employer and employee treatment of the same item would be a dominant feature. Thus the decision of whether there will be additional cash compensation or additional in-kind compensation would not have to account for the tax effect of the employee but would only be governed by the employer's ability to make the payment and the bargaining power of the employee.

In addition to promoting greater efficiency in individual choices and generally in the labor market, taxing fringe benefits under §83 would tend to promote equity both horizontally and vertically. It would also tend to bring a greater acceptance of the fairness of the tax system into being on the assumption that real inequities are coupled with perceived inequities under current law. For these reasons as well as the need to promote greater efficiency in the system, it is appropriate to value fringe benefits for purposes of inclusion at fair market value rather than at employer's cost (except in certain circumstances in which employer's cost can be presumed to be fair market value) or at some other figure. Although there are valuation difficulties created by this rule, they are not insurmountable. In the balance, the added measure of fairness that the §83 result brings to the system is substantial enough to overcome them.

The conclusion as to current taxability again reflects the notion that fringe benefits are in fact compensation and that they should be taxed as such when they are paid. As to the timing question, it is clear that the benefits most affected by a change to §83 treatment would be pensions and other deferred compensation plans. Such a result would hardly be popular, but this radical change should be made despite the fact that saving for retirement is regarded as valuable for society. There are other methods of encouraging such saving, among them the suggestion outlined in Part D. for providing deductions for amounts contributed to qualified plans. If that suggestion were followed, the proposal to tax employer contributions to plans with vested benefits would do no more than shift the focus of the policy of encouraging saving for retirement to a deduction, which would be much easier to administer, and away from the elaborate scheme of current exclusion.

The conclusions may be somewhat different when it comes to Social Security, unemployment insurance and workers' compensation contributions. Although theoretically no different from private retirement plans, when it comes to the propriety of currently taxing employer contributions to Social Security, there may well be sufficient reason to treat government plans-differently from private plans. The same may also hold true for unemployment insurance and workers' compensation. If the policy considerations are sufficient to warrant an exemption from the general scheme of current taxability for employer-funded but government-administered plans of this type, the grant of the exemption should be carefully drafted to include only these items. Technically they are as much a part of current compensation as any other fringe benefit. Thus Congress should carefully weigh the importance of a policy decision exempting them from tax. That is particularly necessary in view of the fact that with respect to both Social Security and workers' compensation (to the extent benefits are used to pay for medical services), and even unemployment compensation to a limited extent, the forgiveness of tax is total. It would probably be better from the standpoint of equity to have a system that taxes employer contributions currently for all of these insurance plans and to opt for continued complete exclusion of the benefits at the time of retirement or disability since that serves the social objective quite adequately.

Another thing that ought to be taken into account in assessing the propriety of the choice of current taxation as opposed to deferred taxation is that in some instances that choice will also coincide with the proper choice of taxpayer. For example, with respect to salary continuation plans that are taxable unless they come within the limited exclusion of §101(b), it is more appropriate to tax the employee currently than the surviving beneficiary since it is the employee who renders the services with respect to which the amounts are paid. To the extent that the beneficiary receives amounts in excess of the employee's contributions (on the assumption that the earnings of the invested plan contributions are not taxed currently to the employee whose rights to them have vested, a not altogether proper result from a policy standpoint, those amounts would be taxable to the extent they exceed the basis generated by prior inclusion in income.

Finally, of course, the solution of using §83 to provide for taxability is both simple and straightforward.

## Part D. Additional Proposals

Although the solution described in Part B is one which is complete unto itself, there are nevertheless aspects to the current system of nontaxation of many fringe benefits that merit some attention. First of all, with respect to funding retirement savings plans, it is quite clear that many members of society believe that only a system which tends to encourage retirement saving will have the result of adequately insuring that the most basic needs of older people are taken care of without resorting to wholesale state-sponsored programs for the retired. Granting that there is some validity to that assumption and, more importantly, accepting that it is indeed useful to promote saving for retirement, it seems appropriate to propose an alternative to current exclusion in the form of a deduction for funds invested in qualified retirement plans.

### 1. Deduction for Qualified Plan Contributions

The principal features of such a deduction would be these: it would be an amount equal to a set percentage of income with a cap on the total dollar amount that could be contributed; it would be subject to increase as a result of inflation; it would be available only for contributions to qualified plans, which would be required to be totally nondiscriminatory as to management of the funds invested no matter what the size of an individual's account. In addition, in order for top-level employees to qualify for the deduction, the amounts they receive from the employer would have to be received as part of a plan that is available to all employees on a nondiscriminatory basis. Otherwise employees would tend only to compensate executives, and the deduction would not encourage the type of behavior it is designed to encourage.

Another important feature of the system here proposed is that the cap should be an absolute cap. Therefore, employer contributions to plans in excess of the amount of the cap would result in taxable income to the employee which could not be offset by the deduction. In addition, if an employee wished to make an additional contribution in excess of the employer contribution, that would be deductible up to the amount of the cap but not in excess thereof. There would also be an overall limit of deductible plan contributions so that no one could cheat on the system by having numerous employers (for example, a number of divisions of the same corporation). It might also be sensible to coordinate the cap with the cap on self-employed earnings contributions so as to further eliminate complexity. This system would presumably be easier to administer than the current myriad of exclusion provisions.

One problem with it would be the need for tightly drafting the nondiscrimination requirements to insure that the purposes of the deduction are adhered to without creating needless complexity in the description of the nondiscriminatory rules. No matter what else such a rule would do, it would have the beneficial effect of eliminating the requirement for complex computations of contribution amounts for defined contribution plans, opting instead for a percentage of employer compensation figure with a cap. Presumably the cap should be set high enough to allow for such flexibility in executive compensation, but it is well to bear in mind that significant discrimination between employer and self-employed plans creates undue burdens on tax administration, so the cap should be similar to that in effect for self-employed plans. Perhaps some compromise would be necessary in order to achieve relative parity.

As a corollary to this rule of currently taxing employer contributions to the plans, there is a need to determine what is to be done about earnings on the contributed amounts and, finally, what the proper method of recovering the investment in the fund should be. As to earnings on the amounts in the fund, the present system of not taxing them currently to the employee is perfectly adequate from a policy standpoint. Not only does that system tend to reduce complexity but it also compare favorably with the way in which annuity investments are taxed, and it would be pointless to discriminate between forms of retirement saving for no good reason. In addition, the policy reason for not taxing the income as it is earned is to encourage this form of saving. There would otherwise be no good reason to invest in this type of plan rather than something else except for the deduction for the initial investment. One assumes that if the deduction is important, then deferring taxation on the earnings on the contributed amount is also important to society.

Finally, what is the proper system of basis recovery under this deduction plan? There are two aspects to this. In the first place it is necessary to determine whether it is proper to recover the investment, including the employer contribution, up front or whether some system of ratable basis recovery is more appropriate policy-wise. Secondly, what happens to the amount of the employer contribution that is deductible; does it give rise to basis? Using ordinary cost recovery analysis, the answer should be that it does not. If a deduction is taken for the amount of the employer contribution then that cost has already been recovered and cannot be recovered again. Thus with respect to amounts that are deducted the changed method of taxation of retirement savings would closely resemble the current system of taxing self-employed plans. The effect of taxing is simply deferred.

As to the proper method of recovering any contributions that have previously been taxed, it is possible to use a system such as that for annuities when the payout is determined on a basis similar to that of annuities. Otherwise it is probably not unduly harsh to spread the investment as a percentage of each benefit payment in a manner similar to the way in which annuities were taxed prior to 1954.

### 2. Increase Zero Bracket Amount

One additional proposal is in order. Despite the fact that base-broadening essentially demands the system of inclusion of fringe benefits in income as proposed in this article, there are nevertheless sound reasons for lessening the harshness of such a radical change by making an across-the-board increase in the §63(d) zero bracket amount of perhaps $1000. If this were done, there would be an amelioration of the burden imposed on individual taxpayers who had benefits from prior exclusions and, in addition, the effect of the increase in the zero bracket amount would apply to everyone. This simple solution should have a great deal of appeal when considered as part of the general proposal I have made. It is hoped that the reason for the increase in the zero bracket amount would not, however, be forgotten. Once this change and the others proposed in this article were made it would be wholly inappropriate to then begin enacting new and different fringe benefit exclusion provisions.

# Initial Impressions of H.R. 3525

Karla W. Simon

July 21, 1983

1. Exclusion classes — Employee Discounts

   A. It seems to me that in the interest of being relatively clear and succinct, §132(b) and (c) ought to be combined. There does not seem to be any reason for allowing an exclusion for the items mentioned in (b) since they are actually items that are furnished at a discount (in the case of §132(b) items, the discount is 100%). I guess it is intended that airline employee discounts would be included under the (b) category, but the test that its setup is much too easy to evade. In addition, the "no foregone revenue" part of the provision puts a premium on being unpopular a rather unjustified policy perspective. If there is going to be any exclusion for employee discounts, it should be confined to certain limits such as those set out in (c).

   B. I do think, however, that there is too much given up in (c). In the first place, it is fairly easy to establish a value for the amount to be included in income if employee discounts were included under §83. Second, there is no aggregate limit on the exclusion. What of the employer such as Sears, Roebuck that is in all sorts of businesses (sales, insurance, financial services, etc.)? Without an aggregate limit, or some clear definition of employer, the proposal can clearly be abused at the executive level, though presumably not at lower levels due to the wording of (c)(3). I am not sure that the nondiscrimination rule of (g)(1) is adequate to alleviate this problem.

2. Exclusion classes -- Working Conditions
   - A. The use of the term "working condition" should not be coupled with "fringe" as a general matter. A working condition is ordinarily not considered to be a fringe benefit, and I think the provision's coupling of the two terms is misleading and unhelpful.
   - B. I too think that working conditions should not be taxed, but I would change certain aspects of the definition.
     1. I would make it clear that the reason for furnishing the working condition is not a compensatory one.
     2. I would add the requirement that a working condition is something which is not lavish or extravagant under the circumstances.
     3. I would not allow the exclusion to extend to personal use of the employer's property. For example, I would permit an exclusion for the use of a car and driver during normal business hours, but I would require inclusion of the fair market value of use for commuting, a nondeductible personal expense.
   - C. The inclusion of free parking as a working condition is unwarranted. Many working conditions have been excluded because they are small and it is very difficult to allocate their value. Neither one of those things is true of free

parking. In addition, it simply extends the workplace to the parking lot, and allows what amounts to a deduction for a personal commuting expense. It also penalizes those who must take public transportation to work or who choose to do so for ecological reasons. Should the exclusion be expanded to cash subsidies for transportation to work? Presumably not, but the argument that it should be will be made.

3. Exclusion classes -- de minimis rule

This is generally good, and it is an exclusion that I favor. What about suggesting an aggregate limit? That may not be a good idea for the statute, but it might have an _in terroram_ effect if it were in the Committee Report.

4. Inclusion of spouses and children

This goes absolutely too far.

5. Recreational Facilities

The idea of linking the employer deduction and employee income inclusion is a good one. I guess I think so because I came up with a similar idea myself for recreational facilities. I would like to see the statute make greater use of this idea. In other words, why should employers be entitled to any deduction under §162 for producing an item that is going to be given to an employee at a 100% discount? Is the expense a business expense under such circumstances?

More specifically as to the recreation facility exclusion, it seems to me that the definition ought to better take into account those employers that are in business which requires them to have "recreational facilities" for business purposes. For example, a manufacturer of sports shoes might well have a track which is used by employees for testing the shoes. Such use is not a fringe benefit. If the facility is made available to the employees for use after business hours, that type of personal use would be a fringe benefit, presumably excludable under the de minimis test, though not under the employee discount provisions because the service (use of the track) is not made available to customers.

6. Having spent only a few minutes putting together these initial thoughts on the proposal, I am even more convinced that the only way to go is to require inclusion of all these items in income. Any other solution is simply too complex and tends to result in serious inequities.

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SCHOOL OF LAW
LOS ANGELES, CALIFORNIA 90024

September 9, 1983

COMMITTEE ON
RECEIVED
SEP 16 1983
WAYS AND MEANS

Mr. John Salmon, Chief Counsel
House Ways and Means Committee
Room 1102
Longworth House Office Building
Washington, DC 20515

Re: H.R. 3525

Dear Mr. Salmon:

I have enclosed a copy of the article to which I referred in my letter to you of July 21. Unfortunately I was unable to present testimony on the August 1 hearing on the bill.

If you will be scheduling another hearing in order to hear the views of Treasury and other additional comments, please let me know. I would, of course, be willing to address myself specifically to the proposal as well as generally to the issue of taxing fringe benefits as I have done in my article.

I would appreciate it if you could have your secretary send me a set of the statements made by the persons who did testify on August 1. I could use that as soon as you can get it to me.

Very truly yours,

Karla W. Simon
Visiting Professor of Law

KWS:ep
Enc.

# A NEW LOOK AT THE TAXATION OF FRINGE BENEFITS

Karla W. Simon*

## Introduction

Defining the term "fringe benefit" for purposes of approaching the subject matter to be addressed in this article has proven to be a difficult task. The choice of a broad and widely comprehensive definition as was made in order to simplify the point of departure. Thus all benefits, facilities or services furnished by employers to employees beyond the bare minimum required for adequate performance of services will be considered to be fringe benefits. Given that scope, the term includes such items as carpet on the floors, pictures on the walls and a receptionist to answer the phone. It also includes far more significant items currently excluded from income under various provisions of the Internal Revenue Code such as employer-funded health insurance and deferred compensation plans. This article will consider all forms of fringe benefits -- from pictures to pensions -- and will propose a mechanism for taxing them, or not taxing them, as the case may be, in one simple system that may be applied to them all.[1]

At the outset, however, it is important to recognize that certain fringe benefits coming within the broad scope of the definition given above are properly excluded from the tax base. The reason is that some items are more properly characterized as "conditions of employment" than as taxable items of compensation. It has been long accepted that items which come within the "working condition" definition are nontaxable though an exact definition of the term is difficult to achieve.[2] The fact that the employer furnishes them simply to provide a better working environment for the employees (an essentially noncompensatory reason) certainly does not remove from them the compensatory value to an employee who might otherwise exist without carpet or pictures, do the work herself or pay for it herself. Yet to suggest that ordinary office furnishings, as opposed to certain relatively extraordinary ones which might well constitute a different matter, ought to be included in income would be similar to suggesting that the psychic income derived from enjoying a job ought to be included in a person's income for tax purposes. Aside from the fact that the idea of including psychic income in the tax base has been mentioned by well-respected commentators (e.g. Henry Simons)[3] the measurement difficulties with regard thereto are obviously extraordinary. The same is true of many fringe benefits. On the other hand, the distortions caused by the wide-ranging exclusions of compensatory fringe benefits (as opposed to noncompensatory working conditions) from income and the importance of these issues for our society are well-known.[4]

The detrimental effect on horizontal equity, for example, has been shown by comparing a person (A) who receives a certain portion of her compensation in cash and the other portion in a selected number of fringes (e.g., child care, health insurance, employer-supplied recreational facilities) and a person (B) who is paid entirely in cash and who must purchase those items out of after-tax income in the open market. The actual amount of disposable income after purchase of the above-mentioned items in B's case stands in stark contrast with A's situation.[5] The perceived inequity can presumably be remedied by requiring that A pay tax on the items now received tax-free from her employer. The questions of what amount ought to be included in income, how valuation should be made and when the item should be included are discussed principally in Part II of this article.

Secondly, the difficulties presented by horizontal inequity in the tax system resulting from the existence of untaxed fringe benefits are compounded by a different sort of inequity, the vertical inequity as between groups of taxpayers who receive fringes but who are in different tax brackets. Taxpayers are thus provided different benefits from untaxed fringes which depend solely on the amount of income they earn which _is_ subject to tax. Like horizontal inequity, the existence of this disparity in amount of benefit seems clear and is demonstrated elsewhere.[6]

Another important aspect of the nontaxation of certain fringes is public sensitivity to the inequities they create. Although the extent to which the public perceives that the tax system is unfair as a result of the tax treatment of various fringes has never been systematically analyzed, it is fair to say that such a perception exists. As a result, it seems apparent that the social cost of continuing to allow broad exclusions for certain types of highly visible benefits may well be too great to continue their existence. It is certainly difficult to document the point at which the sense of the unfairness of the tax system becomes sufficient to cause a person to overcome scruples and fears about cheating, but that point obviously exists for some otherwise law-abiding citizens. To suggest that perceptions of unfairness represent the single most important problem with the current tax system is probably not an overstatement. Thus the issue of which fringe benefits should and which should not be taxed to undo either horizontal inequity or vertical inequity or both must be viewed in that context.

The final method used to demonstrate the distortions resulting from nontaxation of certain frings is to simply point to the statistics which show the magnitude of the "tax expenditure" involved in the exclusion of each fringe benefit on an annual basis.[7] The figures may well be said to be staggering, but the fact that a certain amount of revenue is foregone as a result of the various exclusions does no more than state the obvious. The major issues suggested by the statistics are whether the failure to tax certain fringe benefits is so inequitable on a broad-scale basis as to be unworthy of continuation and whether the exclusions are an inefficient way of doing something that may be worth doing, but perhaps not in the same fashion or to the same extent. These two considerations also illustrate the concern about the allocative inefficiency of fringe benefit exclusions. Thus there is inequity as between groups of employees in industries for which the provision of certain fringes is either easy or fairly inexpensive and employers in industries which do not have that capacity.

Valuation is a significant factor with respect to all fringe benefits. But valuation difficulties should not in most circumstances be the major determinant of taxability or nontaxability. For example, going beyond necessary working conditions into the realm of private secretaries and free parking privileges, one might find that the valuation difficulties, although great, may not be sufficient to outweigh the inclusion of the items in the taxable base in many cases.

Thus it becomes necessary to attempt to create a system of taxation which is not dependent on individual perceptions of worth and which succeeds in taxing to employees those benefits that are compensatory, that are reasonably easy of valuation and that should, from a policy standpoint, be includable in the tax base.

It might well be said, in response to the last statement, that we currently have such a system, that the Internal Revenue Code as written makes the proper distinctions and that we ought to stick with that. There are serious problems with that response. First of all, from an historical standpoint, it is clear that Congress has displayed a great reluctance to deal with the question of fringe benefits in any systematic manner that would attempt to establish a general policy. This problem is addressed in Part I of this article, which also discusses the manner in which the various nontaxable fringes have come into being.

The second difficulty is that current debates about possible changes in our system of taxation have tended not to focus on the issue of fringe benefits, even though it is a pervasive problem. For example, with respect to the scholarly discussions regarding consumption or cash-flow type taxes versus income taxes, it is readily apparent that the question of which fringes to tax and which to exclude under a consumption tax system has the same parameters as in an income tax system.[8] Nevertheless, there has been little mention of this specific issue in the generalized debates about the propriety of the two systems. Turning to the flat rate tax or a tax with broader brackets, the issue of whether or not to include fringes in the base is one of obvious importance,[9] but here again it has only been infrequently mentioned by those expounding the virtues of such a tax.[10]

Looking at the equity-efficiency debate, one also notes a marked lack of attention to the issue of fringe benefit taxation. In point of fact, there is no need to determine whether one is in the camp of reformers who favor equity or that of those who favor efficiency -- wholesale exclusion of fringe benefits from the tax base is both inequitable and inefficient. It is also irrelevant whether one views a shift toward labor income as the major source of revenue-raising efforts as proper, if indeed one perceives that such a shift is occurring. Nor is it particularly important whether one views progressivity as vital to a fair system of taxation. If labor income is going to be taxed at all it seems perfectly proper to say that all labor income should be included in the base, and that it does not matter what rates are applied to that base.

The proposal found here is neutral with respect to all these issues. With the discussion of the proposal as its focus, this article will attempt to inform these general debates about tax reform with a sense of the magnitude of the problem created by nontaxation of fringe benefits. It will also suggest a vehicle for taxing fringes under the current system of income taxation that should serve as a model for other systems that we may move to in the future.

Within the tax system as it currently exists, the scrutiny which this topic deserves seems to increase as time goes by. In an article published in the National Tax Journal in 1953, the authors were highly pessimistic about future prospects for reform:

> . . . [I]t would appear that the taxing authorities may well be in a position where they can either act now or effectively be foreclosed in the future when the practice of not taxing fringe benefits is even more firmly established and any attempt to tax such benefits would be bitterly resisted.[11]

Approximately two decades later the Treasury finally "became concerned by the increasing use of fringe benefits by employers."[12] Since that time, a number of fringe benefits have, for various reasons, been excluded from the tax base.[13] In addition, the Congress has strongly resisted attempts by the Treasury to tax systematically certain other employee benefits.[14] And the importance of fringe benefits as a percentage of total compensation has grown markedly since the 1953 article was written.[15] Although the words of that article may well have been prophetic, this article will attempt to persuade its readers that there is still something to be done and to give some guidance as to how we should go about doing it.

Finally, a note about simplicity. While it is clear that simplification of the tax system is a desirable goal, it is also clear that taxing fringe benefits of necessity involves the addition of some complexity to the current tax system. Using the mechanism provided by §83, as suggested here, to establish a method for taxing fringes in no way reduces that added measure of complexity, since the reasons for the complexity are more factual (i.e. related to valuation) than legal. Nevertheless, the thesis of this article is that a reassessment of the structure of the law as it currently relates to fringe benefits will be a vehicle for reducing complexity as time goes on. The initial debate should provide both the framework for the system of taxation as well as a methodology for assessing future changes in the scope of fringe benefits made subject to tax.

## Part I. The Existing Pattern - Current Exclusions from Income

As the title of this article indicates, it is intended to provide a "new look" at fringe benefit taxation. The new look involves an assessment of the current system of taxing (or not taxing) various fringes and a proposal for providing a mechanism for their inclusion in the tax base. In order to understand the importance of completely overhauling the system of taxation that currently exists, it is helpful to understand what it is and how it came about.

There are essentially three different types of exclusions for fringe benefits in the current tax structure: long-time exclusions codified in the 1954 Code when it was originally enacted, more recent amendments to the Internal Revenue Code, and exclusions by administrative regulation, ruling or "time-honored tradition," which have never been codified. Except for the most recent additions to the Internal Revenue Code that provide fringe benefit exclusions, i.e. those that were added to the Code beginning in the late 1970's, the responsibility for the mishmash of exclusions must be shared by the Congress and the Treasury. The interaction between the two has tended to produce a general broadening of the provisions granting exclusions. Although the Treasury initially took a rather inflexible position that many in-kind benefits constituted income, this generally changed, and the administrative positions became quite lenient.

Almost all of the specific exclusion provisions which found their way into the 1954 Code at the outset had their origins in administrative determinations that the item in question was not properly includable in the tax base, although some grew more directly out of provisions of previous revenue acts. Most of those had their origins in administrative policy, so it is fair to say that the Treasury Department as a whole and the Internal Revenue Service in particular have had a large part to play in the development of fringe benefit policy from 1913 on.

As will be seen from the history of the treatment of fringe benefits that follows, the development of each separate provision of the Code was never coordinated to any great extent with any other fringe benefit provision either as to rationale or as to analysis of the propriety in a larger scheme. Each position that was taken by the Treasury and each provision that was enacted by Congress seemed to stand on its own. What is particularly distressing is the lack of systematic analysis by the Treasury in its own published decisions as to the taxability or nontaxability of certain items and the resulting lack of clear guidance given to Congress when it was considering new Code provisions. It was only fairly recently that the Treasury finally decided to take positions opposed to the continual broadening and extending of exclusions.[16]

The historical treatment which follows will include a critical analysis of the particular exclusion provision or administrative ruling. The general critical discussion of what fringe benefit items might continue to be excluded under the scheme of general includability in income can be found at the end of the article, after a discussion of how the inclusion mechanism would work.

## 1954 CODE AS ORIGINALLY ENACTED

### 1. Deferred Compensation Plans

By far the largest of the current exclusions is the one for employer contributions to pension and other qualified deferred compensation plans for the benefit of employees and their beneficiaries. Coupled with the exclusion for income earned on the invested pension funds, the amount of the tax expenditure for 1982 has been estimated to be in excess of twenty-five and one-half billion dollars, rising to more than forty-eight and one-half billion by 1987.[17] The present exclusion provisions for pension, profit-sharing and other deferred compensation plans are complex in the extreme and provide complicated rules for plan qualification, vesting standards and taxation on distributions.[18] The current system is the product of many years of tinkering with exclusion statutes, the first of which appeared in 1921. Prior to that time, however, the Treasury had clearly indicated its belief that pensions and other retirement benefits constituted taxable compensation. Unlike many other positions which were changed, the Treasury view with respect to inclusion remained firm.

The earliest ruling regarding pension plans, coming at a time when no specific section of the law required inclusion, provided that "pensions or retiring allowances paid by the United States or private persons" were deemed to constitute income.[19] This rule seems to have been announced, again without explicit statutory authority, as a corollary to regulations treating deductions for expenses for employee compensation under the Revenue Act of 1913. The earliest reference to the income tax treatment of pensions is thus found in the rules for determining the deductibility of the amounts paid as ordinary and necessary business expenses in Regulations 33, promulgated under the first revenue acts.[20] Article 136 of Regulations 33 (Revised) denied a deduction for amounts contributed to a trust established for the purpose of paying employee pensions, allowing instead a deduction for "the amount actually paid to the employee."[21] The placement of Article 136 in those regulations clearly suggests that the issue was principally one of distinguishing such payments from "donations" made to employees "which do not have in them the element of compensation" and are therefore nondeductible as ordinary and necessary business expenses.[22] Although the conclusion is not free from doubt, it seems that employer deduction was tied to an inclusion by an employee or other beneficiary. Thus gifts, excludable under the statute of the time[23] as well as now, could not give rise to a deduction whereas "compensation," clearly includable under 1913 Revenue Act Sec. II(B), could.

The early Treasury position requiring inclusion of pension plan contributions in employees' incomes was reversed by Congress in 1921. The first provision dealing with this matter was a part of the section concerning the taxation of trusts and their beneficiaries.[24] Although the new provision did not state specifically that the employer contributions to exempt stock-bonus or profit-sharing trusts were excludable from the income of the employees when made, that result is necessarily implicit in the fact that the beneficiaries were taxable in accordance with the following language: " . . . but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds amounts paid in by him."[25] Except for the 1926 Act, which added pension trusts to this system of taxation,[26] and the 1938 Act which restricted employer access to the funds in order for the exemption to apply,[27] the numerous amendments made during the intervening years to the original provision were designed to insure that any appreciation in value of the stock or other assets held by the trust would not be taxed to a distributee as income.[28]

In 1942, however, a major change was made in what was by that time section 165 of the 1939 Code. Section 165(a) was reserved for the treatment of the trust itself and the qualification of a trust for exemption, while the treatment of beneficiaries of such trusts was moved to subsection (b). Once again, the exclusion for employer contributions was not explicit, but the legislative history clearly supports the implication that exclusion was intended.[29] At the same time, Congress enacted other subsections to deal with beneficiaries of nonqualified trusts. The first of these, subsection (c), of section 165, described the treatment of a beneficiary of a nonexempt trust and stated that such person was taxable on contributions made by the employer in the year in which the beneficial interest in them was nonforfeitable. The second, subsection (d), was intended to give special treatment to employee-beneficiaries of annuity plans and make them nontaxable on the employer contributions despite the fact that the trusts themselves were set up before the 1942 Act and were nonexempt.[30]

Between 1942 and the enactment of the 1954 Code, there was very little legislative activity in the pension area, but in the early 1950's congressional awareness that all was not perfect again resurfaced. Thus two successive acts tried to solve the problem of the earnings on invested pension funds by taxing them according to the source (employer or employee) of the capital.[31] Finally in the 1954 Code a comprehensive scheme for the taxation of pension plans, contributions thereto and distributions therefrom was enacted.[32] Since that time, in addition to frequent tinkering,[33] there have been two substantial amendatory acts that have helped to shape the current scheme of taxation in the pension area.

The Employees' Retirement Income Security Act of 1974 (ERISA),[34] made sweeping changes in the law. A major thrust of these changes was the types of provisions that need to be included in a plan in order for it to qualify for tax exemption and contributions to it to qualify for exclusion. No change was made in the general rule of nontaxability. The ERISA rules, designed to insure fairness in the coverage of tax exempt plans, are used as models for the nondiscrimination requirements of other deferred plans for which there are exclusions for contributions made.[35]

More recently, in 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) made additional fundamental changes in the manner in which self-employed and employer-funded plans are taxed, moving from a system in which there was substantial inequality between the two to a system where the amounts that may be contributed without current inclusion in the income of the employee or self-employed person are essentially the same.[36] These changes were thought necessary to eliminate widespread abuse of professional service corporations as a device to achieve "employee" status and hence to be entitled to greater plan contribution limits. There may, however, be an unintended negative impact on lower-level employees whose employers will change plan contributions to their detriment.

This discussion of the development of the pension plan legislation shows that the general tax treatment of pensions has not varied much since 1921. Thus ever since 1921 the major employee benefit that derives from the exclusion of the contributed amounts has consistently been the benefit of deferral, although combined with that there is a possible reduction in the amount of tax paid as a result of the lower rates that apply to smaller amounts of income (this is particularly true if the taxpayer takes advantage of ten-year averaging). Nevertheless, the issue with respect to the taxability of pension plan contributions is "when" not "whether." Thus the questions that need to be addressed with respect to the taxability of deferred compensation are those concerning timing the taxable event, not whether there is a taxable event. But deferral may in some circumstances be almost as valuable as a complete exclusion if it is for a long enough time.[37]

It is important to note that pension plans are an extremely important factor in the current labor market and in the economy as a whole. A scheme such as the one proposed in the article that would tax currently employer contributions to the plans would be strongly resisted.

### 2. Employee Stock Option Plans

Unlike pension and other retirement benefit plans, the form of deferred compensation arrangement known as a stock option plan had a rather involved history prior to the enactment of the 1954 Code. Nevertheless, by the time of that codification it was reasonably well settled that there are two different types of stock option plans, only one of which, a "statutory" plan, gives deferral. Under a "nonstatutory" plan the employee is taxed on the fair market value of the spread at the time the option is granted if the option has a fair market value; if it does not, the time of exercise is the time of tax. Under a statutory plan, of which there are currently two types, incentive stock options defined in §422A and employee stock purchase plans, defined in §423, the employee is not taxed until the stock is sold at which time any compensatory element is taxed as capital gain. Thus, unlike pensions on which the tax is merely deferred, with stock options the deferral is coupled with conversion of ordinary income to capital gain.

Stock options have been used as employee benefits for a long time, but for many years their tax status was in doubt. The conceptual difficulty which existed for some time with respect to taxing the compensatory element in a bargain purchase of the employer's stock was related to the existence of the two elements of such purchases -- the fact that the transaction itself was a purchase[38] and the fact that it was made for less than fair market value in an employment setting. Noting that "[i]n practically all such cases, both elements are present and decision is impossible if the absence of one or the other is essential thereto," the Board of Tax Appeals in Geeseman v. Commissioner developed what became known as the "propriety interest doctrine," permitting the exclusion from income of any value in the option if its purpose was to encourage equity participation by the employee in the business.[39] The Board held the bargain element of exercise of the options to be nontaxable, relying principally on the fact that there was no interdependence between the grant of the option and the terms of the petitioner's employment. In addition, the facts of that particular case were such that the difference between the offering price and the fair market value of the stock was not terribly significant.[40]

The Commissioner accepted the Tax Court's theory and acquiesced in Geeseman,[41] amending the applicable regulations to distinguish between compensatory and proprietary stock options, holding the former to be taxable while the latter were not.[42] The disparate treatment between the employee paid in cash who was permitted to buy stock and the employee given a "proprietary" stock option was obvious and was not lost on employers and employees who began to demand such options as a part of compensation packages. In addition, there was a disparity in the treatment of bargain purchases of stock and bargain purchases of other items not covered in the amendments to the regulations. Although it is not altogether clear, it seems that bargain purchases of manufactured goods, for example, were considered to be taxable.[43]

Despite the acquiescence in Geeseman, the Commissioner continued to litigate these issues, the disparity in treatment between stock bargain purchases and other bargain purchases continued only until after the Supreme Court decided Commissioner v. Smith in 1945.[44] In Smith the statute was held to be "broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."[45] The amount determined to be includable in Smith was the value of the "spread," the difference between the fair market value of the property and the amount paid for it. Under the facts of Smith, where the Tax Court had held that the option did not have a market value when it was issued, the Supreme Court held that the time for taxing the compensatory element in the option was at the time of exercise.[46] But Smith left open the possibility that if the option could be valued when granted, it might be taxed then, with no further consequences upon exercise. New regulations were issued in 1946 purporting to tax all stock options in that manner.[47]

After the Supreme Court's decision in Smith and prior to its decision in Commissioner v. Lo Bue,[48] Congress sought to reverse the trend toward taxing stock options by providing for certain executive compensation arrangements which would permit deferral for employees. To achieve the desired deferral, the employer was required to transfer a stock option and the stock to the employee in accordance with fairly definite rules regarding "restricted" stock option plans. The new rules were contained in a 1950 Revenue Act amendment, adding section 130A to the 1939 Code,[49] the statutory predecessor of Section 421 of the 1954 Code. In 1964, the continued use of restricted stock option plans was ended and rules under which an option could be received and exercised by an employee without tax consequences were set out in a totally new Section 421 which created "qualified" stock option plans (defined in Section 422) and which was substantially stricter and more limited than its predecessor.[50]

In the meantime Lo Bue was handed down by the Supreme Court. That case reached essentially the same result as Smith, but made it clear that options without a readily ascertainable fair market value (even if they had acknowledged value) were taxable at the time of exercise in the amount of the spread between the option price and the fair market value of the stock on that date.[51] Thus the Lo Bue case created substantial certainty as to the taxable event and its proper timing where stock options are used as compensation for employees by opting, in almost all instances, for measurement of and inclusion in income when it is relatively easy to measure the amount to be included. The result in Lo Bue made the treatment of stock options not covered by the 1950 legislation similar to the treatment of other taxable employee bargain purchases, the timing of the income being deferred until the time of purchase because the right to purchase conferred earlier is too amorphous and thus too difficult of valuation to be the occasion for taxation.

The difficulty with a rule such as that in Lo Bue, which defers taxation until the purchase of stock, is that in an inflationary economy or where stock prices are increasing for other reasons, it produces additional compensation income attributable to appreciation in value of the property subject to the option. Offsetting the pain of having to take an additional amount into income in a deferred purchase situation pursuant to an option is the balm of deferral. Particularly in the case of stock, an employee's worth may be much enhanced, even though his spendable income is not, as a result of ownership of an option to acquire stock whose exercise is somehow restricted.

A similar enhancement of wealth is accomplished when an item of property is transferred outright but subject to restrictions on its complete ownership or use. If the restrictions in the option situation were sufficient to cause the option to not have a readily ascertainable fair market value, the 1946 regulations requiring the inclusion of income not at the time of grant but at the time of exercise would apply and deferral would be applicable. Those regulations did not, however, address the facts described in the situation where property is transferred subject to restrictions as opposed to the option to acquire having being transferred. They also did not offer a solution to still a third possible problem that arises when an immediately exercisable option is granted but the property obtainable upon the exercise of the option is subject to restrictions.

These gaps in the regulations were made more obvious by Kuchman v. Commissioner, a 1952 Tax Court decision that had permitted stock subject to a relatively meaningless resale requirement to be excluded from income in the year of issue.[52] Taken together with Lehman v. Commissioner, decided a year earlier, in which the Tax Court had held that the time of lapse of restrictions was not the proper time for taxing the compensation income,[53] the Kuchman decision created a serious problem for the Treasury in its attempt to enforce a rule timing the taxable event to accord with Lo Bue. These decisions essentially made a valuable share restricted stock, clearly transferred for compensatory purposes, never subject to tax in the hands of the transferee.

The Treasury sought to remedy these difficulties with new regulations, proposed in 1956 and finalized in 1959, designed to eliminate the defects in the earlier regulations. These new regulations set out comprehensive rules governing the treatment of transfers of restricted property and options not covered by §421.[54] More importantly, they clearly distinguished between options with a readily ascertainable value and those without, the former being taxable at the time of grant and the latter at the time of exercise. Only restrictions "having a significant effect upon the fair market value" of the option or of the property subject to the option could be taken into account in determining whether the property had an ascertainable fair market value. In addition, the regulations made a significant change respecting restrictions permitting only those with a significant effect on value to defer the taxable event from the time of exercise of the option or receipt of the property until the restrictions were eliminated.

However, even though the time to tax might be deferred until lapse of the restrictions, the amount to be included under the 1959 regulations was the lesser of the spread at the time of exercise or the spread at the time the restrictions lapse. Thus an employee could own the stock and receive the dividends prior to lapse of the restrictions and nevertheless benefit from having post-exercise appreciation treated as capital gain. Not surprisingly, restricted stock purchase plans tailor-made to fit within the regulations' parameters became very popular because they permitted circumvention of the rules for qualified stock option plans and also placed a clear limit on the amount of income from the receipt of the option that would be subject to tax. In 1968, the Treasury proposed regulations which would have eliminated the benefits available through the use of such arrangements,[55] but the regulations were never finalized because Congress enacted §83 in 1969 to provide clear rules for taxing transfers of restricted property[56]

The benefits available under "qualified" employee stock option plans, were also curtailed at the time § 83 was enacted.[57] In 1976, an even more reform-minded Congress decided to eliminate such plans altogether as of May 20, 1976,[58] and, apparently, to substitute the rule of §83 as the operative provision governing the timing and amount of income includable by the recipient.[59] No amendment to the statute was made, nor does it seem that one was necessary given the broad scope of §83.[60] Nonetheless, the entire matter was rendered moot in a complete policy reversal by the 97th Congress which recreated, with numerous changes, the old "qualified plan" as the "incentive stock option" (shades of Geeseman) under §422A. The rules of the new provision were generally made applicable to options granted after January 1, 1976, and exercised or outstanding after December 21, 1980,[61] thus effectively ousting §83 from the stock option field altogether.

There is one other form of stock option plan which provides deferral under the current statute, the employee stock purchase plan (ESOP) defined in §423. That provision was added in 1964[62] and such plans generally cover a broader group of employees than other option plans. The general benefits (deferral plus conversion) are the same.

### 3. Employee Death Benefits

Turning from pension plans and other deferred compensation plans to the other exclusion provisions in the 1954 Code at the date of its enactment, one finds that they all involve complete forgiveness of tax as opposed to mere deferral on the amounts of the employer payments or contributions or deferral plus conversion. The first of these, the employee death benefit excluded under §101(b), does not amount to much in actual dollars per employee ($5000) nor is it a large enough aggregate amount on a national basis to merit mention in the Joint Committee's tax expenditure estimates.[63] The history of the provision is, however, interesting in that it shows an early lack of sophistication of the Treasury regarding compensation issues.

In its first published ruling on the question of how death benefits should be treated both for the employer and for the recipient of the payment, the government was consistent in its conclusion that the payment should for both parties be given gift status.[64] The position as to the employer was reiterated in the first set of regulations published by the Treasury,[65] but as early as 1919 there was a reversal and without explanation an employer deduction was allowed.[66] Shortly thereafter a ruling giving a gift exclusion to the recipient was issued,[67] the 1919 regulations being silent on this matter.

Finally in 1939 a comprehensive ruling was issued restating and explaining the gift/deduction treatment.[68] The surviving spouse or other beneficiary of the employee not having rendered any services to the employer, it was thought that a payment to such person was entirely gratuitous. It was necessary for exclusion, however, that there not have been a contractual commitment to make the payment, because if there were, that would tend to negative a gift motive. Thus, although employers did not particularly care how they worded corporate resolutions authorizing such payments for their own account, the surviving spouses did, and resolutions were carefully written to fit the language used by the Treasury in its favorable 1939 ruling. Thus the resolution could state that the payment was made for past services, thereby preserving the business expense deduction but also permitting exclusion by the surviving spouse. Contested cases were, of course, numerous.[69]

In 1950, however, the Internal Revenue Service decided to make the stakes the same for both parties to the transaction by issuing a new ruling saying that in all cases the payments made by reason of an employee's death were not to be considered gifts because they were made in consideration of services rendered by the employee even though no services had been rendered by the surviving spouse.[70] In changing its position so radically, the Service indicated that the mistake of the previous rulings had been to focus on the recipient rather than the payor with respect to the rendering of services. The new approach was determined by the Service to be more reflective of the general economics of the situation than the gift theory. But the Tax Court, in a series of cases decided after the change in the IRS position, indicated that it did not necessarily agree.[71] In any case, the inclusion issue was settled by Congress when it enacted the predecessor of §101(b) in 1951.[72]

The legislative history of the new section indicates that the principal motivating force for the change was that in comparing the exclusion from tax for life insurance proceeds with the taxability of death benefits that were not funded by life insurance, it was perceived that there was a "hardship" that needed correcting.[73] Not that the correction was to be a major one, however, as the exclusion was limited to $5000 from the outset, as compared to the unlimited exclusion for the proceeds of life insurance under what is now §101(a). The disparity between the amounts excludable under the two different subsections of §101 has obviously increased since 1954 as a result of inflation.

The 1951 legislation did not resolve the question of whether and under what circumstances a gift exclusion might be available in addition to or instead of the death benefit exclusion. Thus the litigation continued, and there were well-known attempts to whipsaw the government on the deduction/exclusion issues.[74] Congress eliminated one point of contention with the enactment of the 1954 Code when it deleted the requirement of the 1951 provision that the benefit be paid under a contractual agreement. But it was not until the enactment of the $25 limitation on the deductibility of business gifts in 1964 that the deduction issue in this area was resolved in a quite unintended fashion.

4. Employee Health Benefits

By far one of the most common of the fringe benefits available to employees is the provision of accident and health benefits in some form or another.[75] The definition of employee health benefits covers a broad range from the provision of on-site medical services for accidents occurring on the job to the payment of premiums for health insurance to the provision of paid sick leave. There are two basic ways in which funded plans for health benefits are set up: One is to provide them through insurance, with the employer paying insurance premiums on behalf of the employee; the other is where the employer acts as a self-insurer by funding an insurance plan of its own. Under current law the treatment of the alternative methods of accomplishing the same result is the same so long as the amount received from the employer or through insurance is used for medical care. If, however, an amount paid through insurance or by an employer under a health plan is used for ordinary living expenses, there are severe restrictions on an exclusion with respect thereto. In addition to the exclusion of plan benefits, the actual funding of health plans by the employer also does not result in a taxable event to the employee.

It was not always thus, however. Initially, under the 1913 Revenue Act, the Treasury created an exclusion for health benefits which covered "amounts received, through accident or health insurance"[76] This treatment seemed to be merely an extension to non-work-related illness and injury of the exclusion for on-the-job medical treatment, generally considered to be merely a condition of employment. In accord with this rule, the premiums paid by an employer to purchase accident and health policies were held to be income under the regulations.[77] Although the exclusion provision was not enacted by Congress until 1918,[78] it seems that the statute was merely a codification of existing law and that the Treasury probably believed that the interpretation constituted the proper treatment of health benefits as early as 1913.

On the deduction side, Regulations 33 (Revised), held that actual payment "on account of injuries received by employees, or lump-sum amounts paid as compensation for injuries, are proper deductions as 'ordinary and necessary expenses.'"[79] The system of inclusion for payment of premiums or contributions to self-funded plans coupled with exclusion for payments by the insurer or the fund to recompense for medical and other incidental expenses in the case of actual illness or injury continued without change until the early 1940's. In 1943 the Service issued a General Counsel's Memorandum providing that inclusion was required for payments made by employers to individual employees in the event of sickness on the theory that the employer plan did not constitute insurance.[80] In 1953, as a forerunner to the 1954 Code changes, an exclusion was granted for employer contributions to employer-funded group plans.[81]

Beginning in 1954 the original structure was altered in a thoroughgoing manner. The 1953 exclusion for employer funding of accident and health plans at the time premium payment or employer contributions were made was codified. Thus, under §106, employer contributions "to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness" are not includable in the income of the employees. On the other hand, amounts received as compensation for personal injuries and sickness as a result of these employer contributions are generally includable in the income of the recipient under §105(a) but they are not included to the extent that they are reimbursements of amounts "expended for medical care."[82] It is of no small importance that the exclusion applies to reimbursements of amounts paid on behalf of the spouse and dependents of the employer, thus further extending the value of the exclusion for many taxpayers and moving the exclusion far beyond its origins in the jobsite infirmary.[83]

The statutory structure is somewhat more complex than the statements made above would seem to indicate. In the first place, there is a general exclusion provision contained in §104 that basically reflects the old law.[84] Section 104(a) (3) refers to all payments by reason of personal injuries or sickness and thus excludes insurance reimbursement received by an individual who was not covered by an employer plan and who had paid out for her insurance out of after-tax income.[85] (It is, of course, possible that such a person might have had a deduction for medical insurance under §213(a) (2) (available in taxable years prior to 1983) and to that extent the purchase price of the insurance did not come from previously taxed funds.) In a parenthetical, §104(a) (3) states that the general rule of exclusion does not apply to amounts attributable to employer contributions, and although there is no specific cross-reference contained in the statute, the legislative history makes it clear that an employee receiving benefits from plans funded in whole or in part by her employer must look to §105 to determine the extent to which there will be an exclusion.[86]

The major reason for the enactment of §105 was said to be to clear up "substantial" differences in treatment between insurance plans and noninsurance plans under the 1939 Code.[87] In addition, it was designed to clear up "very troublesome" legal and administrative problems having to do with the definition of insurance.[88] But those goals would have been very easy to achieve, and, indeed, §105(e) specifically provides that amounts received under an accident or health plan are to be treated as amounts received through insurance for both sections 104 and 105.

Ignoring the 1954 Code sick pay provision,[89] which has since been repealed,[90] it is clear that the changes made in 1954 were far greater and more fundamental than necessary to remedy the problems Congress thought existed. Under the system in effect now, a person is entitled to exclude both the premium payments or fund contributions by the employer and the insurance or plan proceeds to the extent that they are "expended for medical care." Such an individual is thus in a much better position than the person who must pay part or all of the cost of insurance out of after-tax income. As the exclusion of §105(b) applies to amounts received by employees whose employers purchased the insurance for them, it provides a clear benefit. To the extent that the expenditure of the funds received from the insurer provides a deduction because they are used to pay for medical treatment, the inclusion of the portion attributable to the employer contribution and the taking of a

§213 deduction would produce a wash. But there are two not inconsiderable hurdles that must be crossed before a §213 deduction is ordinarily available. The first is the new 5% floor for the deductibility of any medical expenses added by TEFRA.[91] The second is the zero bracket amount, which is substantial enough to eliminate the separate deductibility of many expenses covered by insurance. Thus it is possible that the entire amount attributable to the employer contribution will not be equaled by a deductible expense, and that this may happen year after year with respect to normal medical expenses incurred. Whenever it happens, the combination of the provisions results in complete exclusion of the employer-paid amount rather than deferral.

The other effect that the §105(b) exclusion has is that it significantly undercuts the limitations on the medical expense deduction imposed under §213. The pervasiveness of health plan benefits as fringes for employees makes questionable the policy behind the increase in the floor in the 1982 legislation. For purposes of raising revenue, it seems far more appropriate to focus on the exclusion for employer contributions found in §106 than to seek to deal with §213 limitations.

With respect to a person who does not have employer-paid health care or insurance there is one possible advantage that may be obtained over the results for a person who receives these fringe benefits. The Service has ruled that amounts received under such a policy were excludable even though they were paid irrespective of the medical expenses incurred but not to the extent they were paid in lieu of wages.[92] In contrast, an employee who is seeking exclusion under §105 has very definite limits on amounts that are excludable other than amounts paid for reimbursement of medical expenses even if they are not in lieu of wages.

As to sick pay specifically, although §105 originally contained a fairly liberal sick pay exclusion, amounts that are paid by the employer or the plan and which exceed the amount of the medical expenses paid or incurred are excludable only in the case of permanent or total disability or dismemberment when the amounts paid are computed without regard to the period of time the employee is absent from work.[93] Amounts that otherwise constitute sick pay which take the form of a wage continuation plan in the event of disability retirement are nontaxable for workers below the age of 65 only when they are paid for a work absence that results from permanent or total disability and then only with the limit of $100 weekly and to the extent that the adjusted gross income from other sources does not exceed $15,000.[94]

On-the-premises infirmaries, the original form of nontaxable health benefit, are not mentioned by the statute presumably because it is still thought to be a condition of employment.[95] As has been indicated, the exclusion of indirect benefits is merely an approximation of the unwritten exclusion for direct, on-site provision of medical services.[96] But the §104 through §106 exclusions go far beyond that because they permit medical treatment for more than job-related injuries and for dependents of the employee who would presumably not be treated at most job-site infirmaries. A final excludable health benefit is one also not provided for by statute is the exclusion of workers' compensation contributions by employers from the income of the employees; this exclusion is discussed in text at notes _____ infra.

It is entirely possible that within the next year legislation will be enacted that puts a "cap" on the amount of excludable benefits under §§104 and 105,[97] although this legislation is not popular with large segments of the public. While a move in that direction is certainly laudatory, it is by no means radical. Indeed, it may be somewhat inefficient in that it adds another level of complexity to the system. Such a cap would, however, tend to preserve the benefit of the exclusion for those who most need it while preventing employers from loading up tax-free fringes for executives.

### 5. Rental Value of Parsonages and Rental Allowances to Ministers of the Gospel

The parsonage exclusion available under §107 of the Code is rather limited. Congress in 1921 decided to provide such an exclusion[98] and thereby override the position that had previously been taken by the Treasury.[99] The reason for the government's position was presumably that the parsonage was not furnished as a working condition by the employer for its convenience, since that was the theory of exclusion that was being developed at the time.[100] Presumably Congress changed the law in favor of the clergy to give an aid to religion at a time when Establishment Clause vigilance was perhaps not so important as it is today.[101]

The first exclusion provision was only for actual in-kind furnishing of housing, but Congress extended the exclusion to cash allowances in 1954 in order to eliminate a perceived unfairness.[102] The §107 exclusion does not appear particularly broad as it is written.

Decisions have been rendered restricting it to actual payments for housing[103] and to ordained ministers or their counterparts.[104]

## 6. Meals and Lodging Furnished for the Convenience of the Employer

The exclusion currently available for the value of meals and lodging reflects the development of an exclusion under administrative rulings and court decisions that proceeded for many years prior to the enactment of §119 in 1954. The newly enacted section was intended to be a codification of portions of prior doctrine as well as a legislative overruling of some prior cases, but the major reason for its enactment appears to have been an attempt to provide clarity and to resolve issues that were litigated with some frequency.[105] Nevertheless, litigation has continued, with the courts being relied upon to resolve a number of issues presented by the language of §119 itself. There is, however, a single major theme running through the administrative, judicial and legislative development: the exclusion will be available if the meals and lodging are furnished "for the convenience of the employer" (and other tests are met). A brief look at §119's development follows.

In keeping with its original policy of requiring inclusion in income of items that vaguely resembled compensation, the Treasury ruled in 1914 that officers and employees of the United States were required to include in income the value of quarters, heat and light furnished to them or the cash allowance paid in lieu of those items.[106] This was the first determination on the subject of meals and lodging furnished in kind to employees, and it is interesting in a couple of particulars. First of all, the ruling contains a reference to the "employer's convenience" doctrine, later to become quite prominent in justifying exclusions, albeit in a somewhat limited fashion. Although the value of quarters or commutation (the cash amount paid in lieu of the furnishing of actual quarters) thereof was held to be includable in income, where "a greater number of rooms than that allowed by law [is assigned], it is assumed that the excess number is assigned for the convenience of the Government, and the money equivalent only of the number of rooms allowed by law shall be returned as income."[107] Secondly, the ruling dealt with items other than lodging, and in the portions of it which consider amounts received as reimbursements for expenditures made or as allowances paid beforehand (per diem or mileage allowances), the ruling clearly requires inclusion only of the amount in excess of the expenses incurred while on government business.[108]

This specific ruling was followed less than a month later by T.D. 2090, a "synopsis" of rulings issued under the 1913 Revenue Act, where its basic position was reiterated. Found in T.D. 2090 is a general statement to the effect that "[w]here an individual is furnished living quarters in addition to salary, the rental value of such living quarters is regarded as compensation subject to the income tax."[109] This result was directly contrary to the roughly contemporaneous English position, found in the House of Lords decision Tennant v. Smith,[110] a case cited by later American cases with approval as setting out the theory of the convenience of the employer doctrine.[111] Tennant v. Smith involved a bank employee who was required to live on the premises and to perform custodian services. Although it was conceded that there was indeed a benefit derived by Mr. Tennant from the occupancy of the living quarters, this did not result in income to him largely as a result of the fact that he was conforming to the bank's wishes in occupying the space and because the value of the occupancy was not convertible to cash.[112] The American administrative agency seemed initially unimpressed with this English legal precedent running counter to its view of the matter.

It is important to note the difference between the original Treasury position and that of the House of Lords. In the Treasury's view, only the value of rooms over and above those needed to perform the services were furnished for the employer's convenience. The value of other rooms was furnished for the employee's convenience, presumably, and was therefore taxable. One can explain the theory by noting that ordinary expenses for the purchase of living space were personal and hence nondeductible. Therefore amounts paid by the employer for such expenses were includable. On the other hand, if an excessive amount of lodging were furnished by the employer that was essentially a working condition and was therefore not income.

The Treasury continued to adhere to its position regarding includability of lodging furnished in addition to wages through 1918, when Regulations 33 (Revised) was published containing the explicit provision in the return filing requirement for the provider of compensation that the value of the lodging furnished to an employee constituted income taxable to her.[113] The principle was, however, eroded only one year later with the publication of two rulings, one regarding seamen[114] and the other regarding Red Cross workers,[115] that signaled the growing acceptance of the English convenience of the employer doctrine in the United States. The first of these involved the in-kind provision of meals and lodging on board ship, while the latter concerned the payment of a cash "maintenance" allowance in lieu of wages which was held to be includable only to the extent that it exceeded actual living expenses. In both instances the unarticulated assumption was that the employee had to be present where she was, not because she desired it but rather because there was no other way that the duties could be performed. Because of that requirement, it seems that the Treasury thought it appropriate to allow an exclusion in these limited circumstances where the lodging furnished by the employer is essentially a working condition. It was particularly the ruling regarding seamen that introduced the broad British "convenience of the employer" notion into the American tax system as justification for noninclusion in income of the fair market value of meals and lodging furnished on board.

It also is important to note with respect to the ruling regarding the Red Cross workers that the amount was paid in cash and not in kind. The next year, 1920, saw the issuance of another ruling that excluded a cash payment, this time for supper money paid when an employee was required to work overtime.[116] The supper money ruling has, significantly, stood the test of time based as it is on the working condition theory. In its latest attempt to deal comprehensively with fringe benefits the Internal Revenue Service has indicated its continued adherence to the "supper money" exclusion.[117] Other cash allowances have been denied excludability, as will be seen.

During 1920 the Treasury published an amendment to the regulations to conform them to its acceptance that employer's convenience is the equivalent of working condition.[118] In the new provision, the reference was to living quarters "such as camps" the value of which was not includable in the income of the employee when furnished for the convenience of the employer, the distinction being drawn between such a situation and one in which the employee was paid a salary as compensation and "in addition thereto [was furnished] living quarters [emphasis supplied]."[119] It seems that in the latter case the living quarters were not furnished as a condition of employment.

The new position of the government was further elucidated in a series of rulings issued in 1921 which considered the application of the convenience of the employer theory to various situations. Perhaps the clearest explanation of the new position was in a ruling with regard to hospital employees who were held to be entitled to an exclusion when they were on call twenty-four hours a day. If not, and if they could "if they so desired, obtain meals and lodging elsewhere than in the hospital and perform the duties required of them by the hospital," they were required to include in income the "ratable" value of the meals and lodging furnished to them.[120] Also, with respect to employees in the fishing and canning industry, an exclusion was permitted where the furnishings of the meals and lodging was required by the "location and the nature of the work."[121]

In two situations no exclusion was allowed. The first involved the furnishing to a clergyman of a parsonage by the congregation.[122] In the second ruling army officers (not enlisted men) were held to have income in the amount of the commuted value of "quarters, light and heat" or the cash equivalent received in lieu thereof.[123] What these two types of individuals had in common and what differentiated them from all the others was the unarticulated assumption that they had a choice of where to live which they could exercise. That conclusion is buttressed by the distinction between Army officers and enlisted men.

In another ruling the Treasury made an attempt to differentiate between employees of the Indian Service as to inclusion or exclusion on the basis of the accounting procedures of the Department of the Interior, their employer.[124] If the Department treated the item as compensation, then it was to be taxed as such, thereby giving effect to the unarticulated theory that the employer's handling of the item is determinative of the employer's convenience question, regardless of the facts and circumstances. Although this ruling exhibits deference to another agency, it is curious when it is contrasted with the ruling regarding domestic servants found in the reporting requirement section of the Cumulative Bulletin. There it was held that the value to the servant of the meals and lodging furnished by the employer should be reported separately by the employer, clearly implying that such amount was to constitute compensation income reportable by the employee.[125] In many such instances one would assume that the employer would regard the employee's presence in the home as mandated by the nature of the services to be performed, but the employer's characterization of the item did not appear to have any bearing on its treatment.

By the early 1920's the Treasury had considered a number of situations in which an exclusion for meals and lodging might be available and determined to grant such an exclusion to both in-kind and cash items if the test of employer's convenience were met. These rulings show a progressive loosening of the employer's convenience doctrine which occurred as different situations were considered. The argument of analogy was clearly more powerful and persuasive than the differences. Nevertheless, there was no attempt to elaborate the rationale of the various rulings and to flesh out the meaning of the test beyond the very limited example of the Indian Service employees cited above in which the treatment by the employer was held to be conclusive.

The government persisted in its original ruling requiring inclusion of meals and lodging in the income of Army officers, and it was this persistence that led in 1925 to the first consideration of the convenience of the employer doctrine by an American court. Jones v. United States,[126] the case that finally overturned the position of the Treasury and granted an exclusion to an Army officer, is the first in a long line of decisions that deal with the question of how the determination of employer's convenience is to be made. The rule was stated in this fashion:

> If the nature of the services require the furnishing of a house for their proper performance, and without it the service may not be properly rendered, the house so furnished is part of the maintenance of the general enterprise, an overhead expense, so to speak, and forms no part of the individual income of the laborer.[127]

Like Tennant v. Smith before it, Jones referred to the example of seamen on board ship.[128] Thus the question of the intent of the employer to compensate or not was insignificant; it was the general facts and circumstances that were determinative. This attention to the facts and circumstances surrounding the furnishing of the meals and lodging has come to be known as the "business necessity view" of the employer's convenient doctrine. As regards the other major question in this area, the cash versus kind problem, the Jones case held, apparently on equity grounds, that cash payments in lieu of the furnishing of quarters are also excludable.[129] The taxpayer achieved a total victory.

Despite this favorable result in the Court of Claims, the subsequent development of the convenience of the employer doctrine took place principally as a result of taxpayer petitions to the Board of Tax Appeals and the Tax Court.[130] The development of the business necessity rationale for the exclusion can be seen in two cases decided by that court, Benaglia v. Commissioner,[131] a 1937 case which involved the application of the rule to a hotel manager, and Van Rosen v. Commissioner,[132] a 1951 decision regarding a cash allowance furnished to a civilian employee of the United States Army Transportation Corps. In Benaglia, where the meals and lodging were provided in kind, the exclusion was allowed, but it was rejected in Van Rosen on the theory that the freedom of disposition inherent in cash was sufficient to render its receipt taxable.[133] It is particularly interesting that the taxpayer's allowance in Van Rosen, like that in Jones, was required to paid as required by United States military regulation but the cash/kind distinction was apparently determinative.[134] The muddied waters that resulted from these varying judicial precedents were not made any clearer by the Internal Revenue Service, which issued a Mimeograph in 1950 declaring the convenience of the employer doctrine to be "simply an administrative test to be applied only in cases in which the compensatory character of [the furnished] benefits is not otherwise determinable."[135] The new IRS position was never elucidated any further.

This was the state of affairs that existed when Congress sat down to write the 1954 Code. The solution that it chose to the meals and lodging problem was §119, which has continued to exist in approximately the same form to the present day. In its 1974 decision in Commissioner v. Kowalski, the Supreme Court makes it clear that the section must "be construed as the draftsmen obviously intended it to be -- as a replacement for the prior law, designed to 'end its confusion.'"[136] In large part §119 did do just that. It certainly eliminated some litigation about the lodging exclusion by setting up very specific tests. But as everyone familiar with the litigation (up to and including Kowalski) under §119 knows, what Congress wanted ain't necessarily what Congress got.

In the first place, there have been numerous decisions interpreting the meaning of the statutory term "business premises."[137] In addition, there was continued need to resolve the cash versus kind question under the new statute as §119 is silent as to the proper treatment of cash allowances. This issue was finally settled in Kowalski, where the Supreme Court held that the statute is intended to reach only items furnished in kind.[138] But there are other minor issues that continue to be litigated, such as whether direct billing of the employer for groceries is sufficient for "in-kind" meals.[139]

There are also remaining issues of major importance that are collateral but closely related to the issues presented by §119. For example, it was not definitively settled until 1981 that the furnishing of meals and lodging to an employee does not constitute the payment of wages for purposes of the Social Security Act and its related provisions.[140] In addition, the Securities and Exchange Commission has expressed concern about the reporting of such items to stockholders as employee perquisites.[141]

It is clear that §119 permits an exclusion for more items than the administrative test used prior to its enactment. The major amendment of the section[142] since its enactment in 1954 shows greater congressional leniency in the unresolved area of spouse and dependent expenses. From litigated cases it is not clear whether previous Service policy had required an allocation and inclusion of those items on the theory that the employer's convenience extended only to the person who is the employee.[143] Thus, like the employee health benefit exclusions, this untaxed fringe has grown far beyond its working condition roots.[144]

The amount involved in the value of this fringe benefit to a given individual will vary, but it may obviously be substantial, a factor which should cut against the retention of the §119 exclusion.[145] Involuntariness does not warrant continuation of the exclusion. Nor can its continuation be justified on the ground that the meals and lodging are working conditions. It is also appropriate to limit a working condition exception to taxability to items that are relatively small and that are difficult to value because of problems allocating them on a per employee basis.[146] It must be noted that allowing an exclusion for meals and lodging is no different from permitting a deduction for a personal nondeductible expense such as commuting. In addition, there is good reason to believe that valuation of meals and lodging would be fairly easy in many instances since the cash wage will be reduced in an amount that the employer thinks is appropriate to compensate for the room and board provided free of charge. In addition, fair rental value can easily be established from readily available comparisons, and allocating grocery costs is not overwhelmingly burdensome.

Finally, it should be noted that there have recently been attempts to expand the coverage of §119 to housing furnished to faculty and administrative personnel by schools and colleges in response to a recently announced IRS policy taxing the fair market value of such housing.[147] Expansion of this already broad exclusion to include an even greater number of people is wholly unwarranted. Although there may be merit to the contention that education needs additional subsidy, surely a direct form is better than such an indirect, back-door approach.

### 7. Special Exclusions for Armed Services Personnel

Toward the close of the Second World War a couple of special exclusion provisions were enacted for armed forces personnel.[148] These were reenacted in the 1954 Code as §§112 and 113. Under §112 as it currently exists, members of the armed forces who are in active service are entitled to exclude "combat pay" received either while they are serving in a combat zone[149] or while they are hospitalized as a result of injuries or disease incurred or contracted on duty in a combat zone.[150] The amount of the exclusion varies depending on whether the person is an enlisted person, noncommissioned officer or a commissioned officer.[151] In addition, §112(d) permits an exclusion for Vietnam War veterans and civilian armed services employees during the Vietnam War who were determined to be in missing status. They may exclude all compensation received during any month they were missing.[152]

Section 113 excludes from income mustering out payments received by service personnel leaving the armed forces.[153] These are generally lump sum items constituting a form of severance pay.

## 1954 CODE AS AMENDED (to 1983)

The next group of exclusions to be considered consists of those that have been enacted by Congress since 1954. The most striking thing about this group of provisions is that only one exclusion section was enacted by the Congress subsequent to 1954 and prior to the late 1970's when new provisions mushroomed. Thus the group of new exclusions is generally of quite recent origin. In addition, except for §79, every post-1954 addition to the ranks of excludable items has no administrative precedent. When one looks at the growth of fringe benefit provisions in the second half of the 1970's from the perspective of the early 1980's it seems apparent that Congress became aware of the fact that it could legislate to provide more fringes only after the Treasury issued its first Discussion Draft of Proposed Regulations in 1975.[154] Thus the interaction of the Treasury and the Congress continues, but since 1975 it appears that the major congressional aim has been to flout the desires of the administrators.

### 1. Group Term Life Insurance

The exclusion provided by §79 for the employer cost of purchasing group term life insurance came into the law in 1964.[155] The exclusion itself is not particularly broad in that it applies to only $50,000 worth of insurance coverage, but in determining the amount that the employer has purchased, any amount the employee contributes to the purchase is credited to the over-$50,000 portion first,[156] thereby significantly enhancing the value of the employer contribution. It is clear from the statute that the type of insurance that may be purchased is only group insurance and that the factors that are permissible for the employer to use in selecting the group tend to preclude individual selection of key employees.[157] The requirements of the statute requiring nondiscrimination were strengthened in 1982.[158] The fact that there is a limitation to "term" life insurance means that there are no savings or other capital value features, such as are inherent in whole life, accruing to the employee as a result of the employer's premium payments.

The origin of the §79 exclusion is much earlier than the enactment of that Code section suggests. The basic reason for the original administrative exclusion was that there was thought to be no significant employee benefit derived from the mere purchase of the insurance by the employer, the benefit derived therefrom being received only by the beneficiaries of the employee after her death.[159] Although the original Service position had been to include in the income of the employee the employer premium purchases for life insurance as well as for accident and health insurance, this was changed with the issuance of T.D. 2992 in 1920 which excluded the employer's cost of group term life from the employee's income.[160] Thus prior to §79's enactment the exclusion policy was more liberal than that granted under the statute.[161]

2. Qualified Group Legal Services Plans

The first of the recent group of fringe benefit provisions is §120,[162] which was designed to encourage employers to make available to their employees access to low-cost legal services through prepaid plans. Although it is unclear what the position of the Service was with respect to payment of employee legal fees,[163] it is safe to surmise that such practices were not widespread particularly with respect to lower level employees. Section 120 thus accomplishes the social objective of making legal services more available than they might otherwise be. An interesting feature of §120 is the fact that this was the first fringe benefit exclusion provision for which Congress specifically set an expiration date when it enacted the original legislation. The so-called "sunset" for §120 provided initially that it would not be applicable for taxable years beginning after December 31, 1981,[164] but that limitation was recently extended by the Economic Recovery Tax Act of 1981 to taxable years beginning after December 31, 1984.[165]

The requirements for a §120 exclusion are that the amounts be contributed by the employer to a "qualified group legal services plan" or that the legal services be provided by or the reimbursement made through, such a qualified plan.[166] The persons who may benefit from such a plan are the employee and her spouse and dependents. The definition of "qualified plan" is lengthy, but the gist of it is that the plan must be nondiscriminatory as to the employees covered and the services provided.[167] In addition, a plan must follow certain notification procedures in order to qualify.[168]

### 3. Qualified Transportation Plans

In 1978, at the height of the energy shortage of the late 1970's, Congress determined that it was good social policy to encourage employers to encourage employees to drive to work less than they had previously. Thus in the Energy Tax Act of 1978,[169] it enacted the provision found in §124 of the Code excluding from income of the employee the value of "qualified transportation" to and from the workplace. Such "qualified transportation" must be furnished in a "commuter highway vehicle," (defined in §46(c) (6) (B)),[170] and the plan must not be discriminatory. In addition, the plan must specifically state that the transportation is furnished to the employee in addition to and not in lieu of compensation otherwise paid to the employee. Once again there is a sunset provision, with the exclusion available only for transportation provided before January 1, 1986.

It is interesting to note that Congress went to some length to indicate that the enactment of §124 was in no way intended to imply that any other employer-provided transportation would be taxable to an employee.[171] Nevertheless, it has quite readily accepted at other times that such transportation will be taxable in certain instances.[172] The expression of concern by the Congress reflects the debates occurring at that time in regard to the taxation of nonstatutory fringe benefits generally.

### 4. Cafeteria Plans

The Revenue Act of 1978[173] was the source of what is the most far-reaching of fringe benefit exclusions ever provided, §125 of the Code, the exclusion for benefits made available under cafeteria plans. What a cafeteria plan does is offer an employee a choice among various benefits, including cash. As to such plans, §125 states that the employee will not be taxable as a result of the choice of any benefit which is otherwise nontaxable simply because of the fact that the employee had the choice to avail herself of the cash option or to take some other taxable benefits instead of a nontaxable one. Thus one of the important branches of the doctrine of constructive receipt is overruled by statute in this area.

The exclusion for cafeteria plans does not extend to deferred compensation arrangements except for qualified cash or deferred arrangements provided by §401(k).[174] Other than that, a pension plan contribution is not permitted to be one of the choices of nontaxable benefits. Otherwise, however, many of the fringe benefits already discussed would qualify as nontaxable choices under a cafeteria plan.[175] Thus an employee who may benefit more from the opportunity to take cash rather than a right to legal services may make that choice and be taxed while the employee who will benefit from the legal services arrangement may make the choice to have the employer fund a qualified group legal services plan on her behalf and escape tax under §120 both on the amount contributed to the plan and the plan benefits when they are eventually paid out. One of the theoretical difficulties with the cafeteria plan approach is that making correct choices as to cash versus kind benefits requires in addition to a high level of sophistication an ability to predict the future with relative accuracy, something few of us possess in any great measure.

As with the provisions that have already been discussed, there are nondiscrimination requirements that must be met in order for the plan to qualify, but the nondiscrimination requirement here is a two-level one: there may be no discrimination as to the nontaxable portion and in addition there may be no discrimination as to the total benefits available.[176] There is a special provision regarding health benefits[177] as well as a provision that a collectively bargained plan is not to be considered discriminatory,[178] which leaves a certain amount of leeway where such fringe benefit arrangements exist. The statute also provides that if highly paid employees do receive more than others they must include in their income the amounts received under the discriminatory portion of the plan.[179]

It is clear from the developments since the enactment of §125, that many view this provision as the heart of the current greater reliance on nontaxable fringes as components of compensation packages.[180] Although many employers seem to be unwilling to use cafeteria plans because of Treasury's continued failure to issue regulations,[181] others seem to be availing themselves of the flexible opportunities provided.[182] The current position of the Treasury is that cafeteria plan benefits are not fundable through salary reduction,[183] but it is obvious that issuing regulations will not clear up all of the problems that cafeteria plans create.[184] They are in many ways skewed in favor of more highly compensated individuals despite the anti-discrimination provisions, and that aspect of the exclusion is not easily correctable.

### 5. Educational Assistance Programs

Enacted in 1978 as one of the Revenue Act provisions, §127 of the Code provides an exclusion for educational assistance program benefits so long as the educational program of the employer qualifies under §127(b).[185] The basic requirements of this section are first that the education must be provided for the exclusive benefit of the employees and not for dependents,[186] thus distinguishing these programs from educational benefit trusts that have generally been held taxable[187] and tuition remission programs of educational institutions that have generally been held nontaxable.[188] Secondly, the education must not involve sports or hobbies,[189] unless such education involves the business of the employer.[190] Finally, the educational assistance plan may not be part of a cafeteria plan.[191]

There are nondiscrimination requirements for plans under which the benefits will be nontaxable.[192] These do not, however, prevent the program from requiring that a participant obtain a certain grade,[193] but they do prevent the employer from limiting the benefits to persons who are seeking only postgraduate degrees, for example.[194] In addition to these restrictions, the section requires that the assistance act not be provided for transportation, tools, lodging and other related items,[195] limiting excludable benefits to tuition fees and books.

There is a proposal currently pending in Congress to extend permanently §127 beyond its expiration on December 31, 1983.[196] This proposal would also liberalize the benefits for which the exclusion is available. Treasury has opposed this legislation.[197]

6. Dependent Care Assistance Programs

The last of the recently added fringe benefit exclusion provisions is §129, added by the Economic Recovery Tax Act of 1981,[198] providing an exclusion from the employee's income of amounts paid or incurred by the employer to provide dependent care assistance under a qualified program. Dependent care assistance is defined by §129(e) (1) with reference to items considered t~~o be de~~pendent care expenses for purposes of the credit for dependent care under §44A.[199] The plan under which the assistance is furnished may not be discriminatory in favor of highly compensated or upper-level employees or in favor of principal shareholders and owners.[200] The employee must be notified of the plan's existence.[201]

Although the definition of dependent care assistance is fairly broad, there is no exclusion available for amounts paid by the employer to the employee's dependents or children under 19 years of age.[202] This provision is clearly designed to limit abuses of the exclusion.

While Congress was vigilant to eliminate certain abuse possibilities in this area, it was not alert to a major problem with the exclusion. Although there is a maximum limitation on the excludable amount (it may not exceed earned income, or in the case of married couples, earned income of the lesser earning spouse)[203] there is no limitation on the cost of the care to the employer that will qualify for the exclusion. Under the §44A credit, the limits on the creditable amount of dependent care are very low ($2400 if there is one qualified individual receiving care and $4800 if there are more).[204] Without any limits on the credit, these limits are essentially read out of the statute for those whose employers provide dependent care assistance care as a fringe benefit.

The group of exclusion provisions added to the Internal Revenue Code since 1975 have nothing whatsoever in common with provisions such as §119 and the health benefit provisions which, despite their current breadth, have respectable origins in the generally accepted notion that conditions of employment are not taxable. As to to the recently added exclusions, the only rationale seems to be that Congress wants to encourage a social policy through the exclusion. Sometimes these policies are not of enduring importance or are misguided. In addition to their being substantively questionable, there has been little or no attempt by Congress to correlate these provisions with each other or with pre-existing fringes or to determine their relative worth either in terms of social policy or in terms of their relative cost in number of dollars of revenue foregone.

## NONSTATUTORY EXCLUSIONS

Although it is in some cases difficult to document instances in which the Internal Revenue Service has determined that certain employee fringes will not be subject to tax (not in the least because many of these result from local office decisions), there are some exclusions without statutory authority that can be found in regulations or rulings. A minor one of these has already been mentioned, the supper money exclusion which first appeared in O.D. 514 in 1920[205] and which continues to be Service policy as evidenced by the current proposed regulations.[206] More significant exclusions are those accorded tuition remission programs of various schools and universities, the employer funding of workers' compensation and unemployment benefits, and employer funding of Social Security. Finally, a number of miscellaneous items will be mentioned, including expense accounts for executives.

### 1. Tuition Remission

The exclusion of tuition remission programs of schools and universities presents in some cases precisely the same issues that are presented by employee discounts generally (those where the institution remits its own tuition for beneficiaries of its employees). In other situations, where there is a consortium of universities remitting tuition of the children or spouses of employees as long as they attend a member school in the consortium, or where the institution pays tuition of dependents of an employee regardless of where the dependent is being educated, create slightly different problems. It is safe to say, however, that the latter circumstances more clearly involve items of taxable compensation than does the former, yet the policy for all three has been the same and until relatively recently remained unquestioned.

The current exclusion for tuition remission programs is found in the Treasury regulations issued to define excludable scholarships under §117. Its source is the legislative history of the 1954 Code,[207] and by its language it is specific to the second kind of program mentioned above. Treasury Regulation §1.117-3 says, inter alia: "If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship."[208]

The wording of this provision is curious. In the first place, according to the regulation's language, there is no exclusion for remissions to a child of an employee by the employing institution. Apparently these payments were thought to be excludable under the general employee-discount exclusion, nowhere written down but clearly in effect at the time. Secondly, there is no provision for spouses of employees. Third, the statement only refers to children of faculty members. Although these latter two lapses in the language might be considered to be a product of the time, one would do well to remember stories about Harvard-educated sons of Harvard janitors. Finally, and most importantly, the focus of the regulation is clearly on the recipient child with respect to whom the amount paid may well not be a scholarship in the ordinary understanding of that term, but who nevertheless has rendered no services to the employer and should thus clearly not be regarded as the proper taxpayer with respect to the item.[209] Despite all these infirmities, the exclusion in the regulations has been broadly applied.

That such a simple statement in the regulations under §117 is the source of the current very broad exclusion for tuition remission programs can hardly be doubted when one considers the response to the first, and wholly unsuccessful attempt, by the government to change the rule. In November, 1976,[210] the Service promulgated new proposed regulations seeking to tax all the various forms of tuition remission programs to employees, but, following hearings about the proposals at which the education lobby appeared in full force, these proposals were quickly withdrawn in January, 1977.[211] They reappeared in the proposed fringe benefit regulations in both 1978 and 1981,[212] but they, like the other parts of the current proposal, are on hold.[213]

There are essentially two very different policy issues presented by the two general forms of tuition remission program. With respect to payments made by an employer to other institutions, continued IRS policy excluding such payments creates a distinction between educational employers and others whose educational benefit programs for employees have consistently been held to be taxable to the employee in the amount of the benefit received by the dependent.[214] This result is unwarranted and makes no sense from a policy standpoint.

As regards programs available for tuition at the employer institution, the issue is the same as that presented by employee discounts generally, but with emphasis on employers furnishing services as opposed to producing products.[215] Analytically, then, the approach to such tuition remission programs should be similar to the approach to other employee discounts.[216] This might seem to suggest the promulgation of a de minimis rule such as the Service has proposed for merchandise discounts. But even if such a rule might arguably be applicable to services that cost less than education, full tuition remission at most schools can hardly qualify as de minimis. In addition, one policy reason for the establishment of a de minimis rule in employer-manufactured merchandise discount situations (the difficulty of defining the market when the availability of items in such a wide variety of different retail circumstances creates many different markets) simply does not exist with respect to compensatory tuition remission programs. Thus it seems proper that there be no de minimis rule and that the amount includable when tuition is remitted should be the full amount not paid regardless of the circumstances.

Obviously there will be some who will have difficulty with such a rule, arguing that the admitted small incremental cost to the employer ought to be a factor weighed in the determination of the amount determined to be subject to tax under this rule. That fact is only relevant if no otherwise acceptable student is not admitted to the school to make space for the employee's child. Otherwise the proper measure of the benefit is equal to the amount of revenue foregone by the employer. To set up a rule that would tax employees of different educational institutions differently solely on the basis of whether the employer was popular and hence had to turn away students or whether it was unpopular and had spaces available in its classes, would be unacceptable as either tax or social policy.

### 2. Social Security Contributions and Benefits

Like private pension plan contributions discussed above, the mandatory contributions made by employers under the Federal Insurance Contributions Act (FICA) are not includable in the income of the employees for whose benefit the contributions are made. The manner in which the Social Security tax is set up requires that employees contribute a certain percentage (5.7% for 1984-1987; 6.06% for 1988 and 1989; 6.2% for 1990 and thereafter)[217] of their incomes to a fund for old-age and survivors' insurance. An additional percentage of each employee's wages equal to that contributed by the employee is paid by the employer as an excise tax[218] and is thus deductible by the employer as a business expense.[219] The amount paid by the employee is deducted from her salary,[220] but that amount does not constitute a deductible expense for income tax purposes.[221] The maximum dollar amount of wages to which the tax applies has risen over the years and the current figure is $35,700.[222] The FICA tax enforces a system of savings for retirement and support for those already retired by mandating annual contributions to a common national fund.

To the extent of the employer contributions which go untaxed to the employee when they are made, the employee receives a double benefit. In the first place, she is better off than a self-employed individual for whom the FICA mandate can only be satisfied by her own earnings without a deduction.[223] Secondly, and in contrast to private pension plan contributions by employers which are eventually taxed to the employee, employer-made FICA contributions are not subject to tax in many instances because Social Security insurance payments are not includable in income unless they exceed a certain "base amount," defined in §86(c) of the Code.[224] While it may well be socially proper to not tax such insurance benefits to retired individuals even to the extent they are attributable to untaxed employer contributions, the unfairness of such a scheme vis-a-vis the self-employed is readily apparent.

It is interesting that there has never been any statutory authority for exclusion either of contributions or insurance benefits under either the internal revenue statutes or the Social Security Act. In addition, a careful search of the legislative history of the original Social Security provisions[225] indicates no intent as to exclusion of these items from income taxation under the then-current Revenue Act of 1936.[226] Nevertheless, in 1938, the IRS determined that lump-sum payments made to "non-qualified"[227] individuals under Title II, §204(a) of the Social Security Act were not subject to tax.[228] Section 204(a) provided for lump-sum payments to people "attaining the age of 65" who failed to pass the tests of total wages paid and number of years worked since December, 1936. The exclusion was extended to lump-sum payments made to the estate of a deceased person ("qualified" or "non-qualified") in I.T. 3229 issued later that year.[229] Neither of these rulings gave reasons or otherwise cited authority for its holding.

Monthly payments received under the Social Security Act were excluded from gross income in 1941.[230] The position taken in that year with respect to monthly payments was updated and restated in Rev. Rul. 70-217,[231] the current authority for the exclusion. As a result of amendments to the Social Security Act, the reach of the later ruling is somewhat broader, but its general thrust is essentially the same. For example, under the current ruling benefits received from either the Old-Age or Survivors Insurance Trust Fund or the Disability Insurance Trust Fund are excludable.[232]

It seems relatively certain that the intent of the Service initially was to treat the benefit payments as excludable because they were similar to general welfare benefits paid by federal, state or local governments.[233] However, to the extent that it ignores the compensatory origin of the contributions to which a part of the insurance benefits must be attributable and on which no tax had been levied, that analogy is invalid. Nonetheless, the Service has always treated the contribution as being excludable from income.

Thus with respect to Social Security benefits the exclusions provided by administrative ruling amounted to a complete forgiveness of tax until 1983. In the Social Security Amendments Act of 1983,[234] Congress changed the complete forgiveness of tax with respect to the social security benefits received subject to tax to the extent that they exceed certain levels. The inclusion is of only one-half to the extent that "modified" (as defined in §86(b) (2)) adjusted gross income exceeds

$32,000 in the case of married individuals filing joint returns and $25,000 in the case of other individuals.[235] The difference between social security and privately-funded pensions remains quite clear. Presumably this difference is justified by the importance of retirement savings and retirement benefits as societal goals to be promoted through a government plan. As suggested in Part III, however, there are clearly other means for accomplishing these ends, assuming that one does not wish to radically alter the current system.

### 3. Unemployment Compensation

Although there is no specific statutory treatment of unemployment compensation, the development of the administrative position indicates the current income tax treatment of such benefits. It has never been clearly stated that employer contribution to plans, whether they be private or government-sponsored, are not included in the income of the employees. Nevertheless, that seems to be the accepted treatment of the contributions despite the fact that the employer is entitled to a deduction under §162 for the excise tax paid under §3301 of the Code.

As to the benefits themselves, the tax treatment seems to be dependent on the source of the compensation paid. Generally, if the plan is funded by nongovernmental sources (e.g. the union the employee belongs to), the benefits are includable to the extent they exceed the employee's nondeductible contributions to the plan.[236] If the plan is government-sponsored, the benefits are generally excludable within certain limitations.

Government unemployment compensation benefits were first determined to be excludable from income in 1938.[237] The original ruling excluding such benefits dealt only with "funds received from the Federal Unemployment Trust Fund,[238] but this rule has been extended to other government programs whose payments are in the nature of compensation for unemployment,[239] even when the recipient must perform some services in order to be entitled to the benefits.[240] This latter position reflects the shift in government attitude in favor of restraining programs as distinguished from mere aid programs.[241]

In 1978 Congress enacted the first limitation on the general exclusion of the benefits from income.[242] Section 85 provides that if a taxpayer's adjusted gross income plus unemployment benefits exceeds a certain base amount,[243] an amount equal to 50% of the excess will be included in gross income.[244] This income-conditioned exclusion is designed to decrease incentives to remain unemployed and the consequent additional cost of government-sponsored programs.[245]

### 4. Workers' Compensation

It is once again difficult to trace the development of the IRS position with respect to the exclusion from income of employer contributions to state-sponsored workers' compensation programs. Like the other forms of social insurance that have already been discussed, the acceptance of the propriety of such an exclusion is general and unarticulated. Nevertheless, in the area of workers' compensation there is one series of rulings from which it can be inferred that the Service intends to exclude employer contributions to such plans from income.[246] These rulings deal with nonoccupational employee disability benefits and the scope of the exclusion for workers' compensation benefits under §104(a) (1). They state that such nonoccupational disability benefits are not in the nature of the benefits intended to be excluded from income under §104(a) (10), and to the extent that the employer contributions to the plan were excluded from income, the benefits themselves are taxable.[247]

As to the benefits paid out of the state-maintained workers' compensation funds, §104(a) (1) specifically provides an exclusion if the funds are used to pay for medical care.[248] To the extent a worker who has a job-related injury collects workers' compensation for it, the exclusion of this fringe benefit is a total one, similar to the exclusion for employer-funded health insurance plans (which workers' compensation closely resembles) when the plan benefits are expended for medical care.

### 5. Miscellaneous

There are a number of nonstatutory exclusions that have not received much attention in rulings or other formal announcements of the Internal Revenue Service until the recent attempts in 1975 and 1981 to deal with nonstatutory fringes. Among these are airline and railroad passes, the latter subject of a terse Office Decision in 1921,[249] employee discounts on items manufactured or sold by the employer and interest-free loans.[250] In addition, there is a valuable fringe available to many highly compensated employees in the form of expense accounts and other items of business-related expense reimbursed by the employer to the employee.

Employee discounts on various items including goods and services which the employer furnishes, manufactures or sells to the public and interest-free or low-interest loans are clearly problems of some magnitude. Many employers make such items available to their employees. Some do so on a relatively nondiscriminatory basis, while others are unwilling to provide the discounted loans or services to any except the most highly compensated. It is not particularly difficult to imagine a rule under which all such discounts would be taxed.[251] Indeed, it seems clear that at least initially the amount of an employee discount was properly includable in income,[252] but at some point this treatment changed.[253] The Treasury has concluded that repetitive items of this sort should continue to be excluded and it has not imposed a nondiscrimination requirement for an interest-free loan program.[254]

With respect to interest-free or low-interest loans to employees, there seems to be no reason to exclude the value of the discount from income. If the discount is included, the employee would be required to justify the interest deduction she is entitled to. With §265 limiting interest deductions if funds are invested to produce tax-exempt income and §163(d) limiting "investment interest" deductions, the rationale for noninclusion advanced in some court decisions[255] is particularly inappropriate. In addition, there is no rational basis for allowing employers to establish a nontaxable interest-free loan program which is discriminatory, as the Treasury seems willing to do.

As to employer-reimbursed expenses, the manner in which the Code is currently administered guarantees a rather substantial fringe benefit as a result of reimbursed employee expenses so long as they are incurred in the employer's business. It has long been clear that certain employer-reimbursed items such as cars,[256] meals and lodging outside §119 that are not related to the carrying on of the employer's business,[257] the use of employer recreation facilities beyond the time required for active business discussions,[258] etc. are taxable as income. But other items such as one's own meal when entertaining a client, an expensive hotel room, first-class air travel and other well-regarded (by the restaurants, hotels and airlines,[259] if no one else) expense account items seem to be largely accepted as perfectly plausible nontaxable fringe benefits.[260] To a very great extent the reimbursement of travel and entertainment expenses is merely a thinly disguised method of paying personal expenses of employees. Once again, it is relatively clear that expense account fringe benefits are available generally to upper-level employees and that they lend themselves to a significant amount of abuse. Although some expenses may clearly be classed as nontaxable working conditions where the employer is satisfied as to their propriety, certain personal items such as the cost of one's own meal should be taxable. Although the trend may well be against large expense accounts for employees,[261] this is a fringe that can hardly be ignored.

## CONCLUSION

It is apparent from the foregoing discussion and analysis that the development of our current system of not taxing fringe benefits to employees has proceeded in a piecemeal fashion with little attention to questions of the policy for the various exclusions or to an attempt to justify each of them in terms of the others. Such an approach to lawmaking is not particularly sensitive to the needs of having a logical system of taxation that would seek to take into account many competing economic and social policy goals in defining the base. Given that conclusion, the most rational approach to dealing with the taxation of fringe benefits would be to start over again from scratch and attempt to reach conclusions as to what benefits should be included in income, when they should be taxed and what amount should be taxable on a more rational and comparative basis. That is what the remainder of this article seeks to do.

Sadly, however, Congress at this writing seems to be incapable of responding to the problems as the development of the foregoing materials indicates that it should. In recent weeks both the House and the Senate have seen the introduction of bills aimed at codifying a system of taxation of fringe benefits that would freeze the current system of exclusions and would add more.[262] Although a detailed discussion of the provisions of the bills is beyond the scope of this article (and is also premature at this point), it should be noted that they would codify the employee discount exclusion currently available under Treasury policy, but would not allow reciprocity. They would also permit the exclusion of the value of free parking as a working condition,[263] and would limit the employer's deduction for recreation facilities unless the employees take the fair market value of the facilities into income.

The pending House bill has been strongly opposed by many lobbying groups on the ground that it does not go far enough, particularly in the limits on reciprocal fringe benefits. At this writing, Treasury has not submitted testimony as to its position on the House bill. The chances of passage of either bill are not easily predictable, due principally to the opponents' lobbying efforts.

This article takes a position that is opposed both to retention of the current system and to the relaxation of the noncodified rules. It proposes that fringe benefits be taxed currently to the employees in the amount of their fair market value. Just how to effectuate such a system will now be explained.

## Part II. Framework for Taxation of Fringe Benefits - Internal Revenue Code §83

In determining how a system of taxing fringe benefits would work as an alternative to the current patchwork of exclusions, two basic policy choices must be made. One concerns the proper timing of the inclusion of the fringe benefit in income, and the other concerns the amount that will be included once the timing problem is settled. One might suggest, for example, that the proper time to tax employer provided health benefits is when the employer contribution to the health plan is made rather than taxing them under the current system when the benefit is paid out. Another suggestion might be that the proper amount of income to the employee as a result of the employer contribution to the plan should be the fair market value of the contribution to the plan. Alternatively, the amount taken into income might be determined to be the employer's cost.

The considerations that go into making the choices among the alternative valuations and times for taxing items of fringe benefit compensation are considerations of policy. The conclusion this article reaches as to the mechanism for the inclusion of fringe benefits in income -- using §83 as the operative provision -- involves clear choices on the questions of timing and amount of inclusion which are rooted in choices must be made. One concerns the proper timing of the inclusion of the fringe benefit in income, and the other concerns the amount that will be included once the timing problem is settled. One might suggest, for example, that the proper time to tax employer provided health benefits is when the employer contribution to the health plan is made rather than taxing them under the current system when the benefit is paid out. Another suggestion might be that the proper amount of income to the employee as a result of the employer contribution to the plan should be the fair market value of the contribution to the plan. Alternatively, the amount taken into income might be determined to be the employer's cost.

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Before going into the policy analysis, this part will explore the use of I.R.C. §83 in providing the mechanism for taxing fringe benefits. As will be seen from the following description, in 1969 Congress developed a comprehensive scheme for taxing compensatory property transfers that was specifically concerned with issues about timing and amount of inclusion, thereby attempting to create some clarity in one specific and troublesome area. Congress may well respond to the taxation fringe benefits with a similar piece of legislation.[264] But §83 is already on the books and, as the analysis which follows will point out, it represents a means of taxing fringe benefits without the creation of a new section of the Code.[265]

Although it is clear from its history that §83 was intended to clear up problems in the area of the taxation of stock option and restricted stock plans,[266] its scope is not limited to these fringe benefits alone. The section is quite broadly written so that its language can encompass compensatory items other than the ones it was specifically directed to without strain. The courts have already chosen to apply §83 to some fringe benefits,[267] and the Treasury has recognized its general applicability in the 1981 proposed regulations.[268] What this article proposes is that the current limited application of §83 be expanded at the behest of Congress to include currently nontaxable fringe benefits of all types. The manner in which the statute would apply to these items is explored in the material in this part.

### A. Section 83's Treatment of Compensatory Transfers of Property

Outright compensatory transfers of property to individuals, which are not considered to be fringe benefits, have always been considered taxable. The Treasury's original position on "compensation not paid in money" was promulgated in 1918: If there was a "stipulated value of the service in terms of money" in such an instance, that value was deemed to be the value of the "thing taken in payment," but if there was no stipulated value the amount of compensation income was to be the "market or reasonable value of the thing taken in payment."[269] Where the transferred property was corporate stock, the 1918 regulations provided for a corporate deduction in the amount of the "actual value of such stock, and the recipient of such stock, if he be a taxable person, will return such stock at the same value as income."[270] This general rule has continued, largely unchanged, in the regulations since 1918,[271] but due largely to confusion surrounding the taxation of compensatory stock options and transfer of restricted stock, Congress thought it wise in 1969 to enact a specific statutory rule governing the taxation of property transfers designed as compensation.[272]

## General Rule of Section 83

There were essentially two congressional concerns addressed in §83: first, the matter of the timing of the amount of income to be included as a result of a compensatory property transfer and, second, what effect restrictions imposed on access to the property should have on the timing and/or the amount to be included. Section 83's complicated language reflects its convoluted history, but it states an essentially simple set of rules. When property is transferred in connection with the performance of services, the amount subject to tax is the fair market value of the property (not taking into account any restriction except one which by its terms will never lapse) less the amount paid for it (if any). The taxable event occurs "at the first time" the person having the beneficial interest in the property has full, unrestricted control of the property (i.e. when the property is not "subject to a substantial risk of forfeiture" or is "transferable."[273] The person who is taxable is the person who performs the services regardless of whether she or someone else receives the property.

1. Definition of Terms - Property

Section 83 applies to transfers of all types of property (real or personal), but not, according to the regulations, to money or promises to pay which are not funded and secured.[274] With respect to money, the reason for the §83 rule is fairly apparent--if cash is received without restriction, it is includable in income at the proper time under the taxpayer's method of accounting.[275] If cash is received by a taxpayer with restrictions on its use by her, it may not be included in her income under certain circumstances, on the theory that the taxpayer is an agent for another[276] or merely a conduit.[277] Such an item will be includable if the restrictions lapse and it becomes available for her use or if the taxpayer appropriates the fund or a portion of the fund to her own use.[278]

The receipt of an unsecured promise to pay is not subject to §83 treatment because it is like an unmatured right to receive income in the future and as such will not result in taxability until the promise is fulfilled[279] or is made more secure by a written evidence of obligation convertible to cash or otherwise susceptible of valuation. This exception from §83 treatment appears to be applicable even in the case of rather sizable deferred compensation arrangements which exist by virtue of an employer's crediting an account on its books and which are not "qualified" under §401.[280] Compensation by use of an unsecured note or other evidence of employer indebtedness is also included in this exception to §83 treatment despite the fact that receipt of a note results in income for the recipient in the amount of its fair market value under §61.[281]

An example of an application of the statute to a funded promise to pay money in the future may be found in cases dealing with educational benefit trusts, a fringe benefit arrangement under which employers contract to pay tuition at various educational institutions for a taxpayer's dependents. What is received under such plans by an employee initially is merely forfeitable right to a future benefit which will not actually accrue until a child of the taxpayer does attend an educational institution and the trust does in fact pay the tuition. Only at the time the promise to pay in the future is converted to money in the form of an actual tuition payment or reimbursement does the right to the payment become nonforfeitable under §83.

Although the courts that have considered the matter have not been concerned directly with the question of whether the receipt of the right itself constitutes a taxable event, they have applied §83 principles in determining that a tuition payment by the trust is taxable to the employee.[282] The same result would presumably have been reached if the Tax Court, which originated the rule in Armantrout v. Commissioner,[283] had chosen to apply ordinary cash method accounting principles and the doctrine of constructive receipt in such cases rather than §83.[284] Support for the Tax Court's reliance on §83 in such cases may be found in §402(b), which deals with the similar matter of the taxability of contributions made by employers to nonexempt employees' trusts and which indicates that inclusion is to be determined "in accordance with" §83.[285] Under the facts of the educational benefit trust cases, the alternative times for taxing the compensation to the employee would be either when the right is received or when the employer makes a contribution to the trust, but at neither of these times does the employee have a matured and nonforfeitable right to a payment on his behalf.[286]

The results in the educational benefit trust cases can clearly be applied to the taxability of other fringe benefits that are initially unfunded and unsecured promises to pay money or to transfer property in the future. Examples of these are the entitlement to employee discounts on goods and services, the analysis of which is developed in Part B, Examples 1 and 2, infra.

### 2. Transfer

As defined in the regulations, the term transfer refers to the time at which "a person acquires a beneficial ownership interest" in the property.[287] Presumably this means less than complete beneficial ownership of the property, since it is implicit in §83 that a transfer of the property may occur before there is a taxable event for the recipient. The regulations describe various factors to be considered in determining whether a beneficial ownership interest has been transferred. There must, for example, be a transfer of some risk of loss[288] in order for a transfer within the meaning of the statute to occur, otherwise the "transfer" is similar to an option to acquire property.[289] Although the grant of an option to acquire property may itself constitute a taxable event if the option has a readily ascertainable fair market value, it is not a taxable transfer of the underlying property.[290] If there is a requirement that property be returned under certain circumstances and the consideration to be paid in such an event is minimal and bears no relationship to the property's fair market value, Treasury Regulations §1.83-3(a)(3) and (5) provide that such a requirement will be taken into account in determining the question of whether there has been a transfer of the property. Whether or not a transfer has in fact occurred is important to a recipient who wishes to elect inclusion under §83(b) since the election is available only when there has been a transfer.

If, for example, an employer gives an employee a car to use for a year for business-connected travel by the employee and tells the employee that after the year she may have title to the car, the question would be whether there has been a transfer of anything within the meaning of the statute until the year lapses. Since there is no transfer of the beneficial ownership of the car until the end of the year, the "transfer" of the car for §83 purposes does not occur until then. The use of the car during the year solely for business purposes would presumably not constitute a taxable event under a reasonable rule excluding working conditions from income. If, however, the car were used for personal purposes, the value of such use during the year would be "transferred" and would be taxable under §83(a).

### 3. In Connection with the Performance of Services

By its terms §83 applies only to service-connected transfers of property and has no application to gifts. It applies to all compensatory transfers whether for present, past or future services,[291] and it applies to transfers of property to independent contractors as well as to transfers to employees.[292] Using §83 in the employee death benefit area would presumably clear up any remaining issues with respect to such compensation for past services.

### 4. Transferable or Subject to a Substantial Risk of Forfeiture

Property transferred in connection with the performance of services may be subject to a variety of restrictions on its use or alienability. These restrictions may affect either the value of the property or the time when the transferee's rights in the property are adequate for it to vest or both. The statute sets up two distinct classes of restrictions on property: "lapse" restrictions and "nonlapse" restrictions, the former being important principally for timing the taxable event and the latter principally for determining the amount to be included in income.

There are two types of restrictions which come under the definition of "lapse" restrictions, those which are substantial enough to defer taxation and those which are not. Of the two types of lapse restrictions, only those affecting "transferability" of the property or making it "subject to a substantial risk of forfeiture" are of the type which, if in existence at the time a transfer by the employer occurs, will result in postponement of the taxable event for the service performer until they lapse. Any other "lapse" restrictions will not defer taxation nor will they be taken into account for valuation. If property is not subject to transferability restrictions and there are no conditions under which it might be forfeited, the taxable event will occur at the time the compensatory transfer occurs.

What happens if the property is subject to restrictions of some sort? Suppose the employer gives the employee as compensation a car to use for three years and says that she may keep it until then and that the title will be transferred to her if she is still employed at the end of the three-year period. Otherwise she must return the car to the employer. Nevertheless, the employee is entitled, under the terms of the agreement she has with the employer, to give that first car to her son after two years and to receive another car from the employer if she does so. How will §83 apply to tax the compensatory transfer of the first car?

The regulations under §83 lump the two significant lapse restrictions together to describe property subject either to transfer restrictions or to substantial risk of forfeiture as "substantially nonvested" property.[293] As a practical matter, this use of one term to describe both kinds of restrictions is warranted by the statute. Property will be taxable to the person who performs services at the time when it is subject to no substantial risk of forfeiture regardless of whether it continues to be subject to restrictions on transferability.[294] Property cannot be "transferable" within the meaning of §83(c)(2) unless it is not subject to a substantial risk of forfeiture in the hands of the transferee. Thus the recipient of the property (whether the person who performs the services or some other individual) may well be able to assign or pledge the property -- in addition to giving it away[295] -- but the existence of a condition which constitutes a substantial risk of forfeiture to the transferee will preclude the occurrence of a taxable event with respect thereto until the condition lapses.

Thus, under the facts of the hypothetical situation above, the employee will clearly have income at the time both restrictions lapse, that is, when the title to the car is transferred to her. The question is whether the earlier expiration of the restriction on transferability should render the car "substantially vested" and thereby trigger the taxable event. That would depend on whether the car would have to be returned to the employer by the son if the employee ceased to be employed by the employer before she had received the title to the car. If the son would be required to forfeit the car, then the taxable event is deferred. If the son would not be required to forfeit the car, the statute seems to require the taxable event to occur at the time the employee gives the car to her son.

An example from a litigated case of how §83 applies to restrictions of another type may be found in Horwith v. Commissioner where, prior to an 1981 amendment which would eliminate this result,[296] stock which was subject to the requirement of section 16(b) of the Securities Exchange Act of 1934 that profits from "insider trading" be disgorged and to no other restriction was held transferable and hence not subject to a substantial risk of forfeiture.[297] The item was therefore includable in income at the time it was received. From the court's handling of the question in Horwith, it is apparent that the more meaningful restrictions on property deferring the taxable event until they lapse are those which constitute "substantial risks of forfeiture" as opposed to those which merely limit transferability. The definition of "substantial risk of forfeiture" is thus extremely important in determining how §83 will apply to any given compensatory property transfer.

Section 83(c)(1) provides that a requirement that an employee continue to render substantial future services to an employer prior to the vesting of property comes within the meaning of "substantial risk of forfeiture" but whether the services required are "substantial" will depend on the facts of a given situation. In Richardson v. Commissioner, for example, the Tax Court held that a forfeiture provision in an agreement deferring payment of compensation by contributions to an nonexempt employees trust (made subject to the rules of §83 by an amendment to §402(b) in 1969) did not constitute a "substantial risk of forfeiture" for §83 purposes.[298] The provision required the taxpayer doctor to render "advice and counsel" to the payor hospital after termination of his services "while his health permits," and if he should "fail and refuse to render such advice and counsel, he shall, after the notice of said breach, forfeit all rights under this Agreement."[299] The Tax Court concluded that there was no indication that the hospital would actually call on the doctor for "advice and counsel" in the future and that absent such an indication that the future services would be required, the statutory standard for deferring taxation was not met.[300] The Court pointed out that, "a practical rather than a formalistic test was intended."[301]

The same general attitude toward insubstantial conditions can be found in Edward L. Burnetta, O.D., P.A. v. Commissioner, where the issue was the deductibility of employer contributions to a nonqualified pension plan, the deduction being conditioned on the inclusion of the amounts in the gross income of the employees under §83(a).[302] Although the amounts contributed were subject to forfeiture if an employee were dismissed for theft of company property or embezzlement, the Tax Court held the possibility of such an event to be too remote for the risk of forfeiture to be substantial.[303] Therefore, the employer was not entitled to the deduction.

The effect of these cases is to ignore conditions that do not impose any real burden on a taxpayer's access to property, and they comport with the congressional intent not to allow tax deferral on the basis of nominal restrictions which exist only for tax purposes.[304] Thus in the case of fringe benefits as well, the requirement that restrictions be substantial and not remote in order for vesting to be deferred would generally result in the current taxability of many items. For example, if there were transfer restrictions attached to a parking permit given by the employer to the employee or if there were a permanent resale restriction on property purchased with an employee discount, those restrictions would not be determinative of the timing of the taxable event. These types of restrictions on the transferability of property are not the type that the statute intended should be taken into account in deferring vesting and tax liability, but they may be taken into account in valuation if they constitute "nonlapse restrictions."

5. Restriction Which By Its Terms Will Never Lapse

"Nonlapse" restrictions imposed on property do not affect the timing of the taxable event but may be taken into account in valuing the property for the purpose of determining the amount includable in gross income. A restriction which by its terms will never lapse (otherwise referred to in the regulations as a nonlapse restriction) is one which by definition is not intended to constitute a substantial risk of forfeiture.[305] The example found in the statute and regulations is a permanent requirement that stock received from an employer be sold or be offered for sale at a formula price (including a permanent right of first refusal at a formula price).[306] An example of a nonlapse restriction in the fringe benefit context would be the restriction mentioned above, a permanent resale restriction on property purchased with the employee discount. Although such a restriction should not defer the taxable event, since it will never lapse, there may be a reduction in value of the item purchased and thus of the amount includable in income as a result of the restriction. Nonlapse restrictions are thus permanent restrictions on the use or the transferability of the property and are enforceable not only against the initial recipient of the property but also against transferees of the recipient of the property.

Nonlapse restrictions must be taken into account in valuing property. With respect to a restriction setting up a formula resale price, for example, the statute specifically provides a rebuttable presumption that that price is the fair market value of the property.[307] This rule seems fair and appropriate, since the reasons for the existence of nonlapse restrictions are by and large unrelated to tax considerations.[308]

## Amount Includable in Income

### 1. If the Time for Inclusion is When the Property Vests

In general §83(a) requires at the time of vesting, the inclusion in income of an amount equal to the fair market value of the property transferred less any amount paid for it. Determining the fair market value is basically a factual matter which may be difficult where the property is subject to restrictions, since many of them will produce a discount from the standard willing buyer-willing seller definition of fair market value. For §83 purposes, however, only a restriction which by its terms will never lapse is permitted to be taken into account in valuation. If the nonlapse restriction is a requirement of resale at a specified formula price, the statute provides in subsection (d)(1) that the price determined under the formula is deemed to be the fair market value of the property unless the Secretary, who bears the burden of proof in this regard, proves to the contrary.[309] This statutory presumption gives little guidance, however, as to how other types of nonlapse restrictions should be weighted.

Going back to the hypothetical of the employer giving the employee a car, if the employer were not to impose any restrictions on the employee's use of the car, the amount includable in income would be the fair market value of the car (say $5000) at the time the car vests in the employee. If, however, the employer requires that the car be offered first to it for $4500 in the event that the employee no longer desires to use it, then $4500 would be the amount of includable income to the employee unless the Commissioner could prove that such a restriction was ludicrous or that the value was actually $5000 despite the employer's right of first refusal. If the employer imposed a restriction on the use of the car, if, for example, the employer told the employee that she could not use the car for out-of-state travel, that presumably would not be sufficient to defer vesting nor would it affect the amount includable in income since it would not constitute a nonlapse restriction.

The reason for that result is that §83 makes it clear that restrictions on the use or disposition of the property other than nonlapse restrictions are to be ignored, regardless of whether they are such that an immediate sale of the property subsequent to its receipt could be made only at a discounted sales price. This may appear anomalous where the restrictions are imposed by law rather than by contract, as were those in Pledger v. Commissioner, where this rule was applied to "lettered" stock not capable of resale without registration or a "no action" letter from the SEC.[310]

The major justification for the general rule of valuation set out in §83 is that any alternative would permit a conversion of what is clearly intended as compensation income into capital gain so long as the property maintains or increases in value and where largely unimportant restrictions are imposed in an attempt to reduce value precisely to achieve this result. This issue would be important with respect to fringe benefits such as restricted stock that have great value and are also subject to market fluctuations than with respect to other fringes.

What is problematic in valuing property by the standard fair market value rule is that an adjustment will be required should the property be sold at the discounted value or should it become less valuable prior to the lapse of the restrictions and be sold after the lapse. Whether the adjustment would be in the form of a capital loss or an ordinary loss has not yet been determined, but an analogy to the current inclusion -- subsequent deduction result in the cash compensation area ought to make a subsequent loss ordinary despite the fact that it results from a disposition of property.[311] With regard to a subsequent forfeiture of property included in income when it becomes substantially vested, the Treasury has provided that a loss resulting therefrom is ordinary to the extent the basis of the property was increased as a result of a recognition of income.[312]

The statutory mandate to ignore restrictions that will lapse ought certainly to reduce the number of cases in which it is alleged that the property transferred in connection with the performance of services has no ascertainable fair market value. Nevertheless, the statute and regulations admit to this possibility in determining the tax consequences of a receipt of an option,[313] and it remains to be seen whether such a rule will be developed with respect to the receipt of other kinds of property. It is certaihly possible that some sort of argument of this type might be made with respect to certain fringe benefits, but a de minimis rule should alleviate problems.

As regards stock options which are not incentive stock options governed by the rules of §422A, and options to acquire property other than stock, the valuation rules of §83 currently apply to the option itself since the "property" for §83 purposes is the option, not the property which can be acquired with it.[314] These rules would become generally applicable to all stock options under the proposal suggested in this article. Thus, if an option has an ascertainable fair market value, it will be includable in income at the time of the grant unless it is otherwise restricted. If it does not have an ascertainable fair market value the proper time for applying §83[315] and, in the absence of other restrictions, taxing the benefit received from the grant of the option is, under the regulations, at the time of exercise "even though the fair market value of such option may become readily ascertainable before such time."[316] The option rules would have limited applicability to fringe benefits other than stock option transfers.

If there is any amount paid to acquire the property subject to inclusion under §83, that amount is subtracted from the amount includable in income. Such a situation might arise where an employee is entitled to purchase employer-manufactured items at a company store for a nominal amount. In such a case, the amount of income is the value of the discount.

If the amount paid for the discounted property is not paid in cash but rather by evidences of indebtedness, the failure to pay cash may in some cases result in postponing the taxable event for § 83 purposes until the obligation is paid.[317] If notes are included in the amount paid, the value of unstated interest is subtracted from the amount actually paid to acquire the property as are amounts paid for the use of the property or for other purposes.[318] A subsequent forgiveness or partial forgiveness of debt included in the amount paid for the property will result in an income inclusion for the year in which the cancellation occurs, but it has not been settled whether the item of income is a cancellation of indebtedness amount or an amount of compensation.[319] If it is characterized as compensation, as it presumably should be, then the taxpayer will not have available the exclusion of cancellation of indebtedness income under §108 nor will the basis of the property be adjusted under §§108 and 1017 in connection with such an exclusion.

### 2. If the Time for Inclusion is an Earlier Transfer of Nonvested Property

Property that is subject to a substantial risk of forfeiture may nevertheless be transferred by the person who performs services. If it is transferred by in an arm's length transfer the rules differ from the rules for gratuitous transfers.

For an arm's length disposition the statute specifically calls for an application of a rule differing from the ordinary §83 rule where there is such a transfer of substantially nonvested property, which accelerates the taxable event to the time of the arm's length transfer. In such a case, §83 operates to characterize the gain received on the transfer. The regulations require the inclusion of the amount realized upon the arm's length transfer, over the amount paid for the property, if any, as compensation income to the performer of services.[320] No further amount will be included as compensation income to that individual or to anyone else even if the property substantially appreciates in value before the restrictions lapse. The rule as to arm's length transfers also applies to the service performer when a gratuitous recipient of the property makes an arm's length transfer of it.[321]

If there is a gratuitous transfer, either inter vivos or at death, the lapsing of the risk of forfeiture will be the occasion of the taxable event. The amount of compensation determined under the general rule of §83 as of that date will be includable in the income of the person who performed the services unless that person is dead, in which event his estate or beneficiary will be required to report the item as income in respect of a decedent.[322] If the transfer is not entirely gratuitous but is nevertheless not at arm's length, §83 continues to apply to the property. The regulations provide for a step-by-step recognition of compensation income by the person who performs services beginning with amounts received in consideration for the transfer and ending with any excess in the fair market value of the property when the property vests over any amount paid for the property plus amounts previously included in income.[323]

It is easy to see how these rules would apply to the employee and the car in the hypothetical mentioned on page _____. If she makes a donative transfer to her son while there is a substantial risk of forfeiture, the taxable event will occur at the time of the lapse of the substantial risk of forfeiture, and the amount included in her income will be the fair market value of the car at that time. If, however, she transfers the property to a purchaser for value at arm's length, the transfer itself creates the taxable event, and the amount included in her income as a result of the transfer is the amount she receives from the purchaser, presumably the fair market value of the car at that point.

3. Under Section 83(b) Election

Deferring inclusion in income from the time property is actually transferred until the time when restrictions which preclude its vesting have lapsed may involve a risk of having the report additional compensation income if the property increases in value during the intervening period. In order to permit transferees an option as to timing the inclusion, Congress provided for a binding election to include the item in income in the year of transfer under §83(b).[324] The election is available only if there has actually been a transfer of the property, and thus a combination of various types of restrictions may prevent the taxpayer from making the election because there has been no transfer within the meaning of the statute.[325] Although the applicability of this election to fringe benefits will hardly be an issue -- except perhaps with respect to stock options[326] -- it is mentioned for purposes of completeness. The amount includable in income where a §83(b) election is made is the fair market value of the property at the time of the transfer less any amount paid for the property.

### Other Rules

In addition to setting out rules regarding timing and amount of inclusion in income, § 83 and the regulations thereunder attempt to provide a complete system with respect to compensatory property transfers. Thus there are provisions regarding income from nonvested property[327] and cancellation of nonlapse restrictions[328] which have only limited opportunity in the fringe benefit area. There are also rules regarding the effect of the transfer on the transferor of the property, and the basis and holding period of the property. The deduction rule is of clear importance for fringe benefit compensation. The other rules discussed here are less so, but they are possibly important if the fringe benefit is an item of tangible property and has significant value.

### 1. Effect on Employer

The availability of a deduction for a payor of compensation in the form of transferred property is under §83(h) predicated upon inclusion of the same amount as compensation income by the person who performed the services.[329] The deduction is, however, available only if the person who transfers the property is the person for whom the services are performed and the deduction is otherwise available under §162 or §212.[330] Section 83(h) thus has the effect of creating a healthy tension between employer and employee in which competing tax considerations may well have a beneficial effect. Since there is little difference between the top rate applicable to corporations (46%) and that applicable to individuals (50%) the discount to be applied to both is theoretically almost the same. But as a practical matter, the corporation may be paying tax at a much lower rate and the employee's deferral may be more valuable than an immediate deduction.

### 2. Basis of Property Transferred in Connection with the Performance of Services

The basis of property to which §83 applies is not mentioned in the statute. The regulations provide that the basis of substantially nonvested property in the hands of any person other than a person who has acquired it in an arm's length transfer (in which event the basis is cost under §1012) must reflect the amount paid for the property as well as any amounts included in income.[331] Once property becomes substantially vested, the basis will be increased to reflect any additional income inclusion. If the property is received by gift, any adjustments required under §1015 will be reflected in the basis as will any §1016 adjustments.

### 3. Holding Period

The beginning of the holding period of property to which §83 applies is geared, not surprisingly, to income inclusion under the statute. Under §83(f) the holding period for substantially nonvested property begins only immediately after the restrictions lapse and there is an amount included in income under §83(a). When an election under §83(b) is made, the regulations provide for a holding period which begins just after the date on which the property is transferred.[332] As to purchasers in an arm's length transfer, the holding period is determined under rules provided in §1223.

## B. Application of Section 83 to Specific Types of Fringe Benefits

The proposal to use §83 as the mechanism for a more comprehensive scheme for the taxation of fringe benefits raises a few significant problems. Apart from the difficulty created by the definition of "property" found in the regulations, the problems are essentially those present with respect to other property transfers prior to the enactment of §83 -- timing and amount of inclusion. Assuming for purposes of discussion that the use of §83 represents a sensible policy decision regarding fringe benefit taxation (the analysis of which is found in Part III), there are essentially three examples which are important to look at. The first of these is relatively straight-forward in that it involves a transfer of tangible property whereas the second two are less so in that they may involve no outright transfer of property in the narrow sense.

Example 1. Employee Bargain Purchase of Refrigerator

In January, 1983, Elmer begins working for Icy Refrigeration which manufactures refrigerators in Smalltown. Icy has a policy whereby all employees may purchase refrigerators at cost plus 10% for the less expensive models and cost plus 25% for the more expensive models. The only restrictions on this policy are that it is available only to current employees who may not purchase more than two refrigerators a year. In January, 1984, Elmer is married and purchases for his new home one of the "more expensive models" for $400. Such refrigerators ordinarily sell in the furniture store in his town for $700 and in discount stores in Big City (200 miles away) for $600.

Applying §83 to these facts, it is clear that the proper timing of the taxable event is not when the unfunded and unsecured promise to pay in the future is made (i.e. when the employment relationship between Elmer and the employer begins) but rather when Elmer exercises his rights under the promise and purchases the refrigerator in 1984. Although there is some clear benefit for Elmer arising from the mere promise that he may purchase the item, there is no basis for measuring the benefit until he actually does.

This result is accomplished under the statute by deferral of the taxable event until there is no longer a substantial risk of forfeiture. Such a risk exists in this instance because the opportunity to purchase at a discount is available only to current employees, and termination of Elmer's employment will terminate his right to make the purchase.

The deferral result is appropriate for reasons of sound tax policy. Not only does deferral eliminate the extraordinary difficulty of determining the fair market value of the promise, but is also avoids the normal administrative difficulties that arise when items are taxed before it is clear that the employee has actually received a benefit from them. It is also in accord with the judicially developed doctrine of claim of right that requires a taxpayer to include an income item only when she has clear title to the item.[333] To require the income to be reported earlier would result in confusion as to timing of income in cases where the right thereto is not firmly established and would not comport well with the system of annual accounting.

Nevertheless, all of the valuation hurdles are not overcome by the deferral. Whenever products are sold in different markets, as is the case in this example, there is considerable difficulty in selecting the market for purposes of determining fair market value. Since the lowest convenient retail market would be the one selected by most taxpayers, it would seem the fairest one to use. Administrative difficulties could be dealt with by promulgating regulations that say that the amount includable under such circumstances would be the difference between the amount paid and the average lowest retail price at which the item is sold. Because it is arbitrary, such a rule raises some obvious inequities, but does seem manageable administratively.

Although this example deals with a manufacturer, the rule would be the same if the employer were a retailer. Thus in neither of those circumstances, with respect to tangible items, does the employer's cost determine the includable amount. The amount would be determined with reference to the general market, not the market in which the taxpayer buys.

Under §83, if Elmer were to have his employer transfer a refrigerator to one of his friends or family members, the general rule would apply to tax him on the spread between amount paid and fair market value of the refrigerator at the time that person bought the refrigerator at discount. It should make no difference if Elmer disposes of the right to exercise his employee discount to someone else for cash. In such a case he has simply managed to realize a portion of his compensation in cash and should be taxable when it is received.

Example 2. Airline Employee Discounts

Sammy Steward is an employee of Inter-American Airways. He lives in Los Angeles, but the flights he works are based in San Francisco. Inter-America makes available to him, when space is available, the opportunity to fly free on any of its flights in the continental United States. By paying half-fare the flights are available to Sammy by reservation. His spouse and any dependents are also able to fly on any of these flights for half-fare. In addition to these fringe benefits, Inter-America pays for Sammy's flights to and from Los Angeles so that he will be in San Francisco at the appropriate time for his scheduled working flights.

Once it is accepted that exercise of the right to use the employer's services below cost constitutes an item of property, the application of §83 to these facts is relatively easy. As in Example 1, it seems clear that the proper time for the taxable event for Sammy is not when he is promised free travel to New York, but rather when he makes the trip. The same is obviously true of half-fare flights for his family. Thus the results are the same under §83 whether the fringe benefit is a tangible item manufactured or sold by the employer or a service furnished by the employer. If these items are made available to the employee at a price which is below the price he would pay in the marketplace, the amount to be included in the income of the employee is the difference between the amount paid and the fair market value.

Although there is some difference between these obviously personal flights and of transportation between Los Angeles and San Francisco, it seems apparent that the same result ought to follow for the latter trips. The travel in question is essentially commuting, a personal and nondeductible expense for all employees, no matter how long the commute may be. Thus having the employer pay for this expense should result in income to the employee with no corresponding deduction for the employee. To hold otherwise would put Steward, an airline employee, in different circumstances from a railroad employee named Flowers,[334] and that hardly seems appropriate.

The amount includable under §83 is the fair market value of the airfare. With respect to the space available trips, the amount would presumably be figured on the standby fare, whereas with the half-price and commuting trips the amount includable should be the difference between what is actually paid and the lowest available coach fare.[335] There are some obvious difficulties in valuation present here as in Example 1 where the items that are received are discounted in some markets. The rule of valuation suggested may appear inequitable in certain individual cases, but that those should not prevent the adoption of a relatively simple administrative rule.

Example 3. Payment of Insurance Premiums by Employer

Edna Explorer is employed by Lost Ark Expeditions. Her job entails many hazardous trips to exotic lands. In order to provide for her safety and comfort in carrying out her duties, Lost Ark pays premiums on accident and health insurance for Edna. The only carrier that will write such insurance is Lloyd's of London, and the premiums are $3000 annually, payable January 1, of each year. Although Edna is covered by the policy while she is employed by Lost Ark, should she leave Lost Ark's employ, a refund will be paid to the company.

Applying §83 to these facts, the first issue to be confronted is whether there has been a "transfer" of "property" by virtue of the payment of the premium. This is more than a simple transfer of money. A contract right is treated in Edna and the benefit that accrues to Edna when an insurance policy is purchased in her name by Lost Ark is a transfer of a property right to her. Obviously, the result might be more apparent if there were an actual physical transfer of the policy to Edna, but §83 should not be interpreted in such a narrow and formalistic way. Applying §83 to these facts has the same result as applying constructive receipt principles,[336] so it is clearly not a radical result.

The second question is whether there is a substantial risk of forfeiture in the terms of the insurance contract so as to defer vesting. The answer is that the refund clause does not constitute such a risk. Her coverage is conditional on her employment (the rendering of substantial future services per §83(c)(1)), but for the period of her employment she is fully covered, and the cost of that coverage on an annual basis is $3000. Should she quit and an amount be refunded to Lost Ark, she would have a lesser amount included or, if the events were to span more than one taxable year, she might have a claim for refund or a deduction. Claim of right principles suggest this result.[337]

Again the real problem is the fair market value of the contract right. The difficulties that are present in the example here are inherent in all situations in which an intangible fringe benefit is purchased by the employer and then made available to the employee. It will be true in any number of cases that the employer will be able to take advantage of certain economies of scale in the purchase of the items in question. That is ordinarily true with respect to group insurance plans where the employer pays the premiums. The fact that there are economies or, conversely, special circumstances that increase the cost to the employer (as suggested by the case of Edna and Lost Ark) must have some bearing on the amount that is included in the employee's income under §83. But the fact that there has been a purchase by the employer should not suggest that in all cases the includable amount of a fringe should be the employer's cost.

In the first example, which deals with a manufactured, tangible item, equity seemed to demand that the includable amount be measured by the general market price of the item. The same might be said in the case of large group insurance plans where the cost of the plan can reasonably be said to represent a general market price. In other words, the standard should be that employer's cost will be used as a rule of convenience for purchased intangible items where the number or amount of items purchased is adequate to establish a market.

In circumstances where that is not the case, i.e., where the number of items purchased is insufficient to establish a separate market, the rule of convenience would not apply and the general rule of fair market valuation would be used. How does that effect Edna? Presumably under the test just stated, her includable income from the purchase of the insurance should be $3000 if that is the amount that anyone would have to pay for this insurance. If the amount paid by Lost Ark is greater than the amount anyone else would have paid simply because of the insurer's experience with that company, the amount includable by Edna should also be the lesser amount under §83.[338] Presumably such a rule would reflect the fact that the greater cost to the employer occurred because of its needs rather than hers. If the rule were otherwise, i.e. if $3000 were includable, it might be better economically for both Lost Ark and Edna if Lost Ark were to pay her the cash and have her purchase the insurance herself, a suggestion they might or might not be willing to follow.

There are also issues of valuation raised by Edna's lack of choice in the matter. Despite some judicial expressions of concern,[339] the proper amount to be included in income should not be affected by compulsion as to what is purchased with one's compensation income. After all, this was presumably part of the job description and if Edna wanted the job but didn't want to bear the cost of the tax on the insurance herself, she presumably could have bargained for more salary to ease the pain.

In addition to ignoring compulsion as a factor in valuing fringe benefits for purposes of their inclusion in the tax base, one can also ignore the fact that payment in kind does not give the taxpayer cash with which to pay the tax liability. What is being considered in this article are fringe benefits, and the taxpayer can in ordinary circumstances be expected to have a certain amount of cash income from which the tax can be paid. This is thus essentially a matter that should be left to the bargaining table. There may be extreme circumstances, as in the case of company towns,[340] where the value of the fringes is so great that the includable amount will exceed normal cash wages, but these are so rare as to not detract from the propriety of the general rule.[341] In addition, any argument that is based on this type of consideration need only be carried to its logical conclusion to demonstrate its fallacy: a person who is so successful in negotiating a compensation package so as to include only "nontaxable" fringe benefits is the best argument in favor of a rule which would tax them.

The rule developed in this example is one from which a general rule, applicable to all funded promises to pay in the future, can be extrapolated. The taxable event is the funding of the promise, either by paying for an item such as an insurance policy, an annuity or a parking permit or by self-funding the promise by contributing on an employee's behalf to a fund set aside for her which will pay benefits in the future. Thus a person will pay tax on the benefit received from having the fund made available even though she may never make use of it (e.g. never be sick). The foregoing logic would suggest that there be the same result when the funded promise to pay in the future is a retirement plan. There is no good reason why furnishing retirement security by purchasing an annuity should be taxed currently when contributions to "qualified" deferred compensation plans are not.

These three examples cover a range of various possibilities for taxing fringe benefits under §83. The first and second ones deal with unfunded promises to pay and opt for inclusion when there is an actualization of the benefit received by the employee. The third recognizes that when there is a financial outlay by the employer on behalf of the employee which is nonforfeitable, the time for the inclusion is when the expenditure which gives rise to the benefit occurs. With respect to the question of valuation, the general rule of §83 would ordinarily apply and the market would be the market in which the general public purchases the item in question. In some circumstances when the fringe is an intangible benefit purchased by the employer a rule of convenience is espoused which would use employer's cost when it seems properly, from an objective standpoint, to accord with market valuation.

These three examples do not, however, deal with the need to distinguish taxable fringe benefits and nontaxable working conditions. Nor do they consider the possibility of the need for a de minimis rule. Those issues and others regarding the policy aspects of this proposal will be developed in Part III.

## C. Additional Proposals

Although the proposal to tax all fringe benefits under §83 of the Code is complete unto itself, it is important to recognize that such a system may have certain drawbacks. Thus two additional proposals are made here to complement that scheme of taxation and to reflect certain equitable and social goals.

Retirement savings plans occupy a special place in our tax system and may continue to require special rules under the scheme of taxation just explicated. It is quite clear that many members of society believe that only a system which tends to encourage retirement saving will have the result of adequately insuring that the most basic needs of older people are taken care of without resorting to wholesale state-sponsored programs for the retired. Granting that there is some validity to that assumption and, more importantly, accepting that it is indeed useful to promote saving for retirement, it seems appropriate to propose an alternative to current exclusion in the form of a deduction for funds invested in qualified retirement plans. It is also appropriate to adopt a rule that will help to lessen the burdens on employees who will suddenly be required to pay tax on previously untaxed items. An adjustment in the zero bracket amount is proposed to accomplish that result.

### 1. Deduction for Qualified Plan Contributions

The principal features of such a deduction should be these: it would be limited to an amount equal to a fixed percentage of income with a cap on the total dollar amount that could be contributed; the cap should be subject to increase as a result of inflation; it should be available only for contributions to qualified plans that are available to all employees of a particular employer on a nondiscriminatory basis. Otherwise employers would tend only to compensate executives, and the deduction would not encourage the type of behavior it is designed to encourage. The deduction should be available for voluntary employee contributions as well as for employer contributions to a plan.

Another important feature of such a deduction as here proposed is that the cap should be an absolute cap. Therefore, employer contributions to plans in excess of the amount of the cap would be taxable income to the employee which could not be offset by the deduction. In addition, if an employee wished to make an additional contribution in excess of an employer contribution, that would be deductible up to the amount of the cap but not in excess thereof. There would also be an overall limit of deductible plan contributions so that no one could cheat on the system by having numerous employers (for example, a number of divisions of the same corporation). It might also be sensible to coordinate the cap with the cap on self-employed earnings contributions so as to further eliminate complexity.

This system would presumably be easier to administer than the current myriad of exclusion provisions. One problem with it would be the need for tightly drafting the nondiscrimination requirements to insure that the purposes of the deduction are adhered to without creating needless complexity in the description of the nondiscrimination rules. No matter what else such a rule would do, it would have the beneficial effect of eliminating the requirement for complex computations of contribution amounts for defined contribution plans, opting instead for a percentage of employer compensation figure with a cap.

Presumably the cap should be set high enough to allow for such flexibility in executive compensation, but it is well to bear in mind that significant discrimination between employer and self-employed plans creates undue burdens on tax administration, so the cap should be similar to that in effect for self-employed plans. Perhaps some compromise would be necessary in order to achieve relative parity.

As a corollary to this rule of currently taxing employer contributions to the plans, there is a need to determine what is to be done about earnings on the contributed amounts and, finally, what the proper method of recovering the investment in the fund should be. As to earnings on the amounts in the fund, the present system of not taxing them currently to the employee is perfectly adequate from a policy standpoint. Not only does that system tend to reduce complexity but it is comparable to the way in which annuity investments are taxed,[341] and preservation of neutrality makes it undesirable to discriminate between forms of retirement saving. In addition, the policy reason for not taxing the income as it is earned is to encourage this form of saving. There would otherwise be no good reason to invest in this type of plan rather than something else except for the deduction for the initial investment. One assumes that if the deduction is important, then deferring taxation on the earnings on the contributed amount is also important to society.

Finally, what is the proper system of basis recovery under this deduction plan? There are two aspects to this. In the first place it is necessary to determine whether it is proper to recover the investment, including the employer contribution, up front or whether some system of ratable basis recovery is more appropriate. Second, what happens to the amount of the employer contribution that is deductible; does it give rise to basis? Using ordinary cost recovery analysis, the answer should be that it does not. If a deduction is taken for the amount of the employer contribution then that cost has already been recovered and cannot be recovered again. Thus with respect to amounts that are deducted the changed method of taxation of retirement savings would closely resemble the current system of taxing self-employed plans. The effect of taxing is simply deferred.

As to the proper method of recovering any contributions that have previously been taxed, it is possible to use a system such as that for annuities when the payout is determined in a way similar to the way in which annuity payments are made.[342] Otherwise it is probably not unduly harsh to spread the investment as a percentage of each benefit payment in a manner similar to the way in which annuities were taxed prior to 1954.[343]

### 2. Increase Standard Deduction (Zero Bracket Amount)

Despite the fact that base-broadening and increasing equity essentially demand the system of inclusion of fringe benefits in income as proposed in this article, there are nevertheless sound reasons for lessening the harshness of such a radical change by making an across-the-board increase in the §63(d) zero bracket amount of perhaps $1000. If this were done, there would be an amelioration of the burden imposed on individual taxpayers who had benefits from prior exclusions and, in addition, the effect of the increase in the zero bracket amount would apply to everyone. This simple solution should have a great deal of appeal when considered as part of the proposal made in this article. It is hoped that the reason for the increase in the zero bracket amount would not, however, be forgotten. Once this change and the others proposed in this article were made it would be wholly inappropriate to then begin enacting new and different fringe benefit exclusion provisions.

## Part III. Policy Analysis

Having demonstrated the lack of systematic thought involved in the development of the current scheme of nontaxation of fringe benefits and having demonstrated as well a sensible alternative for taxing such items, the next question is what fringes ought to be subjected to this new regime. As was stated in the introduction, the main point of this article is that all fringes should be taxed to employees under §83 unless there is some weighty policy or administrative convenience reason for exempting them. This part of the article will explore that idea and propose some factors that should be taken into account in defining the categories that should be taxable.

### A. Possible Exclusions

#### 1. Working Conditions

First of all, it is appropriate to accept the generally recognized position that working conditions are nontaxable and that §83 should not be interpreted to include such items in income. But there is little agreement as to what that term means. Thus some discussion is in order to arrive at a definition of working condition that is generally acceptable and results in only the proper items being excluded from the tax base.

The definition of working condition used by the Service in the 1981 proposed regulations draft, "any item furnished by the employer either to enable or to facilitate the performance of employment services by the employee,"[344] is a useful and thoughtful one and can be accepted as a place to start. But it does not suggest the reasons behind the definition as well as it might. The major rationale for a working conditions exclusion is that such items are provided by employers for noncompensatory reasons, and language to that effect would be a useful complement to the definition used by the Service.

In addition, in establishing an appropriate test for defining excludable working conditions, one should look to the business expense area for guidance in making the judgment as to what should be includable and what should not. It would be helpful to add to the definition the phrase "other than items which are lavish or extravagant under the circumstances." Thus, under the rule developed here, the executive or the movie star who is provided with a car and driver by her employer for work-related transportation would not be taxable on the value of those services while she is going from place to place when she is working even though her secretary might be taxable if she received the same benefit. The working condition rule would not, however, exclude the fair market value of commuting in the same vehicle since that would not be related to facilitating her employment services.[345]

The other issues that arise in defining working conditions for purposes of making an exception to the general rule of includability are administrative convenience and nondiscrimination. To a certain extent, discrimination in the benefit furnished would suggest that it is compensatory, but the rule should permit some differences as to perquisites depending on the status of the employee. The added language precluding lavish or extravagant expenditures would tend to aid in making proper distinctions as would the stated requirement that the item be furnished for noncompensatory reasons. As to administrative convenience, it is clear that valuation and allocation difficulties are a major component of a decision to make an exception for working conditions. Thus administrative convenience is taken into account in the rule set out here.

2. De Minimis Rule

Another possible exception to the general rule of inclusion might be a de minimis rule for fringes which, unlike working conditions, are only indirectly related to job performance. Presumably there should be one, but the scope of the exception is difficult to describe. An example of a situation in which a de minimis rule could be used might be with respect to employer-provided recreation facilities.[346] It might make sense to allow an exclusion for truly de minimis employee use of recreation facilities that the employer has provided for the purpose of carrying on its trade or business (i.e., a manufacturer of sports shoes might have a testing track which it permits employees to use before and after business hours). But if the employer erects a special recreation facility for its employees, reliance on §83 for setting up a mechanism whereby fringe benefits would be taxed suggests that the employer should be precluded by §83(h) from taking away deductions for the facility (depreciation, salary for janitorial employees, water, etc.) unless and until the employees who used the facility were required to take into income the value of the benefit they received.[347] Requiring the employer to establish its entitlement to a deduction in this fashion puts a burden on it to do the necessary record-keeping required to properly allocate the benefit of the recreation facility among the employees who use it.

This example suggests that a de minimis exception would be required to be quite limited. In order for the exception to apply, the employee fringe benefit would have to come about because of incidental use of employer services or property. The rule should not encompass situations in which the employer would not be entitled to a deduction with respect to an item unless the item is taken into income by employees.

### 3. Administrative Convenience

There is then the question of whether there are any items in addition to working conditions and minimal fringes that ought to be excluded for reasons of administrative convenience because of the difficulty of valuation or otherwise. Given the scope of the exclusions previously discussed, it does not seem that a separate administrative convenience exception is necessary. A brief discussion of two candidates for such a rule will explain this conclusion.

One of the principal possibilities for exclusion on administrative convenience grounds is employee discounts on the purchase of employer products. The Stark-Conable legislation contains such an exclusion,[348] and the Service has proposed such an exclusion in the proposed regulations.[349] The principal problem with both of these approaches is that they require valuation anyway. It seems that if valuation is required there is no good basis for the exclusion, other than a policy decision which is at odds with the thesis of this article.

As to free parking also excepted by the Service on administrative convenience grounds,[350] the answer is not so clear. If one begins with the assumption that the employer's paying for personal, nondeductible expense on the employee's behalf ought to constitute income to the employee, one should end with the idea that free parking ought to be included in income. That result would suggest that the rule is simply an extension of the rule that personal use of an employer car to and from work is taxable and that the trips between Los Angeles and San Francisco in Example 2 in Part II.B. above are also taxable. Under this analysis it would be pointless to come up with examples of employers in the country who have vacant lots adjacent to their plants where they let employees park as a good reason for excluding free parking in Los Angeles (where it may cost as much as $200 per month) from income. The employees who use the vacant lot would presumably have no income anyway since the fair market value of the parking is at or near zero, and if it has value that would be excluded under the de minimis rule.

On the other hand, the choice made by the employer as to where its business is conducted might have some bearing on the issue of includability of free parking to the employee. Under this analysis the employer's decision to pay for parking in Los Angeles is simply a means of putting its employees in a position that is no worse than they would be in if the place of employment were on the outskirts of Ventura. If the second line of thinking is the more appropriate one, then the proper place for the exclusion for free parking would be as a working condition, and therefore an administrative convenience exception to the general rule would not be necessary for such benefits. This statement is not intended to resolve the question of whether there should be an exclusion for the value of free parking, it is merely intended to point to the proper way of treating such an exclusion.

4. Other

Finally, one must consider the question of the propriety of changing the current scheme of taxation so radically at a time when certain fringes have become a way of life, so to speak. That seems hardly persuasive as a rationale for continuing any current exclusions both because the possibility of grandfathering here would produce unlimited complexity in what is essentially a simple proposal and because such an approach to change seems unnecessary.[351] This article does propose an increase in the zero bracket amount to partially eliminate the economic burdens of such a change. Another suggestion might be to phase in the system over a ten-year period. But no grants of exclusion should be given simply because the fringe benefit has been nontaxable for a long time.

There may, however, be social goals which Congress wishes to continue to further through the grant of an exclusion for a fringe benefit. As this article suggests, a comprehensive analysis of all currently nontaxable items on a comparative basis should be made and there should be an attempt to weight priorities of these tax expenditures against direct expenditures as well. Simply creating grandfather clauses for current exclusions would not satisfy this suggested overhaul of the system.

## B. Propriety of the General Rule

This article suggests that fringe benefits of all sorts should be included in income under §83 of the Code. The proposal thus has two essential parts: 1) that the amount includable in income should be the fair market value of the fringe benefit, and 2) that the proper time for taxing the item is when the benefit actually occurs. The propriety of the choice of §83 as the mechanism for taxing all fringe benefits has been developed through a legal analysis and is justified by that legal analysis as a method of reducing complexity and increasing fairness in the taxation of compensation. This essentially legal conclusion is buttressed by economic and political considerations which will now be briefly explored.

The conclusion that fair market value is the proper measure of the amount of income is based on the assumptions that the only reason for making a payment that we characterize as a fringe benefit is a compensatory one and that the amount of the fringe benefit reduces or should reduce the actual cash compensation paid to the employee in an amount equal or nearly equal to the value of the fringe. The amount of the reduction of the cash compensation will not always be precisely equal to the fair market value of the fringe partially because the actual value of the fringe to any given employee may be difficult to determine. In addition, there may be a wide difference between employer cost and employee value and it is not clear how the saving by the employer is shared. Nevertheless, there is some rough parity between the reduction in cash compensation and the value of the fringe and the decision as to what the makeup of a compensation package will be is dictated by the awareness of this fact on the part of both the employee and the employer.

Currently this bargaining between the employer and the employee is skewed because there is an additional factor taken into account in the process, the nontaxability of fringes. That makes them far more valuable to the recipient employee than cash income and may thus encourage the employee to opt for items which are nontaxable simply because they are unrealistically cheap compared to items that must be purchased with after-tax income. It has been suggested that this result tends to be inefficient both for the individual employee and for the economy as a whole, since it tends to encourage inefficient choices in all compensation decisions that are bargained in any significant way.[352]

The proposal that is made here would be tax neutral as to cash or kind compensation on the employee's side of the matter. With respect to the employer's side, the principal disadvantage of using a §83 rule to tax fringe benefits (aside from obvious valuation and allocation difficulties) would come with respect to deferral of deductions under §83(h) when inclusion is deferred because an item is subject to a substantial risk of forfeiture. This result could have certain beneficial effects in encouraging the earlier vesting of benefits that are part of the compensation package. In this way symmetry between employer and employee treatment of the same item would be a dominant feature. Thus the decision of whether there will be additional cash compensation or additional in-kind compensation would not have to account for the tax effect on the employee but would only be governed on the employer's ability to make the payment and the bargaining power of the employee.

In addition to promoting greater efficiency in individual choices and generally in the labor market, taxing fringe benefits under §83 would tend to promote equity both horizontally and vertically. It would also tend to create a greater belief in the fairness of the tax system which today suffers from both real inequities and perceived inequities. For these reasons as well as the need to promote greater efficiency in the system, it is more appropriate to value fringe benefits for purposes of inclusion at fair market value rather than at employer's cost[353] or at some other figure.[354] Although there are valuation difficulties created by this rule, they are not insurmountable. In the balance, the added measure of fairness that the §83 result brings to the system should be substantial enough to overcome them.

The conclusion as to current taxability again reflects the notion that fringe benefits are in fact compensation and that they should be taxed as such when they are paid. As to the timing question, it is clear that the benefits most affected by a change to §83 treatment would be pensions and other deferred compensation plans. Such a result would hardly be popular and would probably be politically infeasible, but the change proposed here could be made despite the fact that saving for retirement is regarded as valuable for society. There are methods of encouraging such saving other than the current exclusion, among them the suggestion outlined in Part II.C. for providing a deduction for amounts contributed to qualified plans. If that suggestion were followed, the proposal to tax employer contributions to plans with vested benefits would do no more than shift the focus of the policy of encouraging saving for retirement to a deduction, which might be somewhat easier to administer.

The conclusions may be somewhat different when it comes to Social Security, unemployment insurance and workers' compensation contributions. Although theoretically no different from private retirement plans, when it comes to the propriety of currently taxing employer contributions to Social Security, there may well be sufficient political reason to treat government plans differently from private plans. The same may also hold true for unemployment insurance and workers' compensation. If the policy considerations are sufficient to warrant an exemption from the general scheme of current taxability for employer-funded but government-administered plans of this type, the grant of the exemption should be carefully drafted to include only these items. Technically they are as much a part of current compensation as any other fringe benefit. Thus Congress should carefully weigh the importance of a policy decision exempting them from tax. That is particularly necessary in view of the fact that with respect to a substantial part of Social Security benefits the amount of workers' compensation benefits used to pay for medical services,[355] and unemployment compensation to a limited extent,[356] the forgiveness of tax is total. It would probably be better from the standpoint of equity to have a system that taxes employer contributions currently for all of these insurance plans and to opt for complete exclusion of the benefits at the time of retirement or disability since that would tend to adequately serve the social objective.

One final consideration that ought to be taken into account in assessing the propriety of the choice of current taxation as opposed to deferred taxation is that in some instances that choice will avoid the transfer of tax liability to someone other than the employee taxpayer. This will frequently be true if spouses are divorced and the various benefits become part of a marital dissolution settlement. Another exception of this aspect of current taxability concerns funded salary continuation plans that are taxable unless they come within the limited exclusion of §101(b). It is more appropriate to tax the employee than the surviving beneficiary since it is the employee who renders the services with respect to which the amounts are paid.[357]

## Conclusion

This article has demonstrated a method of taxing all fringe benefits under I.R.C. §83 which is both simple and straightforward. That the §83 alternative is a sensible one is developed by an historical analysis of the current system which demonstrates how badly it needs reform. The scheme set out here represents a "new look" at the taxation of fringe benefits that would eliminate the complexities and inconclusiveness in the system as it currently exists. It is hoped that this article will be effective in informing the current legislative debates about the taxation of fringe benefits and in persuading the Congress and the Treasury that fundamental change in the direction suggested is indeed necessary.

## FOOTNOTES

* Associate Professor of Law, Seton Hall University School of Law; Visiting Professor of Law, University of California, Los Angeles. I wish to thank my colleagues at U.C.L.A., Bill Klein and Michael Asimow, for discussing parts of this article with me. I am also grateful to Harry Graham of the Senate Finance Committee staff for helpful discussions at a time when I was beginning to despair that I would never be finished. Most importantly I would like to thank my colleague and husband, Richard Hobbet, whose intellectual and emotional support have been invaluable. In addition, the research assistance of John Bank has been quite a help.

1. This article will not, however, address taxation of items such as paid vacations and flexible work schedules that are considered to be included within the broadest definition of the term fringe benefit. Such items are included by the Bureau of Labor Statistics in its compilation of employee benefits. See U.S. Dep't of Labor, Bureau of Labor Statistics, Employee Benefits in Industry, 1980, Bulletin 2107, 1-2 (1981). The reason for not including them is that the compensation paid for periods which are not worked is already taxed as income. Perhaps it might be better to suggest that amounts paid for leisure should be taxed at a higher rate than other amounts, but development of the theory supporting such a result would lead to unnecessary complications that would detract from the general thesis advanced here.

2. The use of the term "working condition" or "condition of employment" is fraught with the same difficulties due to imprecision as is the use of "fringe benefit." For discussions of the two terms, see,

e.g., J. Sneed; Configurations of Gross Income 101-104 (1967) [hereinafter cited as Sneed]; H. Macaulay, Fringe Benefits and Their Federal Tax Treatment 4-8 (1959) [hereinafter cited as Macaulay]; H. Simons, Personal Income Taxation 52-53 (1938) [hereinafter cited as Simons].

Justice Arthur Goldberg, when he was counsel to the CIO, urged a broad interpretation of the term "working conditions" for tax purposes; see Goldberg, "Compensation Other Than Cash," a paper presented before the Section of Taxation at the American Bar Ass'n, September 18, 1951, cited in Guttentag, Leonard and Rodewald, Federal Income Taxation of Fringe Benefits: A Specific Proposal, 6 Nat'l Tax J. 250, 252-253 (1953) [hereinafter cited as Guttentag, Specific Proposal].

In a curious confusion of the two concepts, the recent proposed legislation which would tax certain currently untaxed fringe benefit items refers to one category of excludable benefits as the "working condition fringe." See Permanent Tax Treatment of Fringe Benefits Tax Act of 1983, H.R. 3525, 98th Cong., 1st Sess. §2(d) [hereinafter referred to as the Stark-Conable Legislation or Stark-Conable]. The effect of the exclusion of the items described in the bill under that hearing is discussed at page __ infra.

See also MACAULAY, supra at 7, where he notes that "conditions of work have also become important in compensating employees."

See also, Proposed Treasury Reg. §1.61-18 (draft) [hereinafter cited as Prop. Reg.], P.H. 1981 Fed. Taxes ¶70,181 at 70,182.1 (not in Federal Register). The proposed regulation defines a working condition as "any property, service or facility provided with the specific intent either to enable or facilitate the performance of employment services." In addition, a working condition must generally be provided at the recipient's place of employment and during normal working hours.

3. See Simons, _supra_ note 2 at 53.

4. Mathematical demonstrations of inequity may be found in Richmond, Tax-Free Fringe Benefits and Social Security: Is it Time to Change the Rules?, 6 Nova L.J. 83, 89-91 (1981) (demonstration of horizontal inequity) [hereinafter cited as Richmond]; Popkin, The Taxation of Employee Fringe Benefits, 22 B.C. L. Rev. 439, 450 (1981) (demonstration of vertical inequity) [hereinafter cited as Popkin]. See generally Nolan, Taxation of Fringe Benefits, 30 Nat'l Tax J. 359 (1977) (analysis from the standpoint of simplification); Note, Federal Income Taxation of Employee Fringe Benefits, 89 Harv. L. Rev. 1141 (1976) (presenting as "Framework for Analysis" the various aspects of inequity and inefficiency, _id_. at 1142-1148).

5. See Richmond, _supra_ note 4 at 91.

6. See Popkin, _supra_ note 4 at 449-451.

7. Tax expenditure projections for 1982-1987 are available in Joint Committee on Taxation, Table 1 - Tax Expenditure Estimates by Function, reprinted in 14 Tax Notes 699, 703 (March 15, 1982).

8. A consumption-type tax system would require that certain expenditures be taxed and that others be exempted from taxation. If one were to determine that expenditures for food, lodging, etc. were to be taxable, then the need to decide whether employer-provided housing, meals and other personal expenditure items should be included in the tax base at their fair market value is obvious. If certain expenditures

such as pension fund investments are considered to be exempt from tax, then a mechanism is needed to provide for the nondiscrimination elements of such a deduction. In other words, the determination of what the base is and what fringe benefits provided by the employer as compensation are to be included in it presents a problem of the same magnitude for a consumption-based system as for an income-based system.

With a pure consumption system it would also be necessary to determine the treatment of expenditures by employers on behalf of their employees in cases in which the expenditures did not fall into the category of tax-favored expenditures. For example, under a consumption system, an employer's providing housing for an employee would presumably be a nontaxable expenditure if it were compensation and business related compensation were treated as a nontaxable expenditure. Given that treatment, there would be no symmetry problem because such housing would be a nontaxable expenditure at the employer level and a taxable expenditure at the employee level.

To a certain extent, the present system shares features of both consumption and income systems by favoring certain kinds of expenditures over others. Pension plan investments are one clear example of the use of consumption theory in an income tax context. This article retains that amalgamation of concepts with respect to investment in pension plans.

For general discussions of consumption tax proposals, see Andrews, A Consumption Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974); Warren, Fairness and Consumption-Type or Cash Flow Personal Income Tax, 88 Harv. L. Rev. 931 (1975); Andrews, Fairness in the

Personal Income Tax: A Reply to Prof. Warren, 88 Harv. L. Rev. 947 (1975); Blueprints for Basic Tax Reform, Chapter IV, A Model Cash Flow Tax (U.S. Treasury Department, 1977).

9. It seems fairly apparent that a change from the current progressive tax system to a flat rate system without some attempt to require the inclusion in the income base of a number of fringes would put even more pressure on the labor market and would tend to shift people into those jobs that provide the best untaxed fringes. It might well be that as a result there would be development of the capacity to provide more nontaxable benefits in those sectors of the economy which had theretofore not been seen as providers of a significant amount of fringes, but the evening-out period might prove to be dislocative for many people. The current trend in compensation is toward more and more fringes, and as a result, allocative inefficiency may be expected to increase.

10. In the Most recent "Flat Tax" bill introduced in Congress, the "Fair Tax Act of 1983," S. 1421, 98th Cong., 1st Sess. [hereinafter referred to as the Bradley-Gephardt bill, or Bradley-Gephardt], the problem of fringe benefits in the system was recognized. The bill would eliminate the most flexible of the current exclusions, that for cafeteria plans (discussed infra at page ___). In addition, the exclusion for dependent care assistance plans and qualified transportation plans would be repealed, employer purchases of group term life insurance for employees would be taxable as would employer purchases of health insurance or funding of health plans except in very limited circumstances. In addition, the bill would make all unemployment

compensation includable in the tax base. While these changes are quite far-reaching, they do not amount to the repeal of all exclusions currently in the law. It seems therefore appropriate to suggest that additional analysis of these matters by the bill's supporters is justified.

Some mention has been made by the Reagan Administration of the need to include fringe benefits in the tax base, but it is not clear what definition should be given to that term. See remarks of Gregory Ballentine, Deputy Assistant Secretary of the Treasury for Tax Analysis quoted in for Feb. 14, 1983 Tax Notes at 655. But apparently the administration more recently retreated from that sort of musing as a result of election year pressures. See New York Times article cited as Tax Notes for August 22, 1983, at 670.

The increased revenue that would be received if nonstatutory fringe benefits were included in the current tax base has been estimated at $1 million for each of 1984-1986. See Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options, 250-251 (1983) quoted in statement by CBO Director Alice RivlinRivlin at Hearing, June 28, 1983 before Senate Finance Committee on Federal Tax Expenditures.

11. Guttentag, Specific Proposal, supra note 1 at 251. See also Sneed, supra note 2, at 101: "It can only be observed that as the community grows richer and the employer, rather than the marketplace, increasingly comes to be regarded as the source of consumption items in kind, the scope of 'working conditions' increases while that of compensation decreases."

12. See testimony of John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, June 22, 1983 Hearings [hereinafter Hearings].

13. See text at notes , infra, discussing post-1978 amendments to the Internal Revenue Code adding new fringe benefit exclusion provisions.

14. In 1975 the Treasury published a discussion draft of proposed regulations on the taxation of fringe benefits. See Proposed Treas. Reg. §1.61-16 (Discussion Draft) [hereinafter cited as 1975 Discussion Draft], 40 Fed. Reg. 41,118 (1975); P-H 1983 Fed. Taxes ¶8907. In 1977 Congress imposed a moratorium on the issuance of fringe benefits regulations, which was later extended by various provisions of other revenue laws until December 31, 1983. See Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, §3, 92 Stat. 3097 (1978) (Oct. 1, 1977, through June 30, 1978); Act of Oct. 7, 1978, Pub. L. No. 95-427, §1, 92 Stat. 997 (May 1, 1978, through December 31, 1979). A further extension was imposed by the Act of Dec. 29, 1979, Pub. L. No. 96-167, §1, 93 Stat. 1275 (1979) (until May 31, 1981). The Economic Recovery Tax Act of 1981 [ERTA], Pub. L. No. 97-34, §801, 95 Stat. 172, 349 (1981) imposed the present moratorium which expires at the end of this year. Although the previous moratorium had ended May 31, and ERTA did not pass Congress until August, the Treasury Department complied with Congressional wishes that it promulgate no regulations during the period that ERTA was in the works. See Daily Tax Report (BNA), June 17, 1981, at G-2.

Despite the moratorium, Treasury did follow its earlier proposed regulations with another discussion draft issued in proposed form in January, 1981. See id., note 2 supra.

It is not clear whether Congress will extend the current moratorium, and, if so, what effect that will have on the proposed regulations. See speech of Assistant Secretary of the Treasury for Tax Policy, John Chapoton to the National Assoc. of Tax Administrators quoted in Daily Tax Report (BNA) No. 125, at G-5, G-6 (June 28, 1983).

There is even legislation currently pending that would forever prohibit the Treasury from issuing fringe benefit regulations! See H.R. 262, introduced by Congressman Quillen, January 17, 1983 Tax Notes at 245.

15. In the years 1947 through 1957, companies reporting to the United States Chamber of Commerce reported that all fringes, including paid leisure such as vacations rose from 15% of payroll to 23.7%. These statistics are cited in H. Macaulay, supra note 2 at 10. In a letter he wrote to constituents in December, 1982, Congressman Barber Conable, the ranking Republican on the House Ways and Means Committee suggested that fringe benefits at "top companies now amount to 35-40 per cent of the total cost of payroll." See text of letter quoted in January 3, 1983 Tax Notes, at 15. See also, "Employees Get More Benefits," N.Y. Times, April 17, 1982, at 30, col. 1.

16. Treasury opposed the extension of the $127 exclusion for educational assistance programs. See statement by William S. McKee, Acting Deputy Assistant Secretary for the Treasury for Tax Policy, at Hearing on April 29, 1983, by Senate Finance Committee Subcommittee on Taxation and Debt Management, Daily Tax Report (BNA) at J-8 (April 29, 1983).

The position of the Treasury regarding any new fringe benefit legislation has been cautious. See Chapotan testimony, Hearings at _____, supra note 12.

17. See Joint Committee, Tax Expenditure Estimates, supra note 4.

18. I.R.C. §401 et seq. For an analysis of the current statute, see generally, 1 B. Bittker, Federal Taxation of Income, Estates & Gifts ¶60-62 (1981) [hereinafter cited as BITTKER] and the articles cited therein.

19. Regulations 45, Article 12, 21 Treas. Dec. Int. Rev. 180 (1919).

20. Regulations 33 were first promulgated in 1914 under the Revenue Act of 1913, ch. 16, 38 Stat. 114. Apparently, the official promulgation of the Regulations was contained in T.D. 1944, which should be found between T.D. 1943 and T.D. 1945 in the official Treasury Department publication of Treasury Decisions. However, volume 16 of the series of Treasury Decisions (which was allegedly published in 1915) contains a blank space where T.D. 1944 should be found on page 26. This is so despite a reference to T.D. 1944 in the index at 314. At the back of volume 16 and bound with it one finds, however, the entire "Regulations No. 33, Revised," which were promulgated on January 2, 1918. Thus the reference to revenue acts.

21. Regulations 33 (Revised), Article 136, 16 Treas. Dec. Int. Rev. 73 (1918). The deduction was for amounts paid as pensions to retired employees and their families and dependents as pensions. This is distinct from amounts paid in continuation of an employee's salary to his widow or heirs "in recognition of the services rendered by the

individual," which were not determined to be deductible because they were not "ordinary and necessary." Regulations 33 (Revised), Article 137, 16 Treas. Dec. Int. Rev. 73 (1918). This difference in treatment was eliminated in the next set of regulations promulgated, which were pursuant to the Revenue Act of 1918. See Regulations 45, Article 108, 21 Treas. Dec. Int. Rev. 204 (1919).

22. Regulations 33 (Revised), Article 135, 16 Treas. Dec. Int. Rev. 73 (1918).

23. See Revenue Act of 1916, ch. 463, §4, 39 Stat. 756.

24. Revenue Act of 1921, ch. 136, §219(f), 42 Stat. 227.

25. Id.

26. Revenue Act of 1926, ch. 27, amendment #28, 44 Stat. 9. The intent was to make pension trusts subject to the "clear and more definite method of taxation" that then applied to stock bonus and profit-sharing trusts because existing laws as to how pension trusts were to be taxed was "not clear." See Conference Comm. Report, H.R. Rep. No. 356, 69th Cong. 1st Sess. 35 (1926).

27. See Revenue Act of 1938, ch. 289, 54 Stat. 447.

28. See Revenue Act of 1928, ch. 852, 45 Stat. 791; Revenue Act of 1932, ch. 209, 47 Stat. 169; Revenue Act of 1936, ch. 690, 49 Stat. 1648.

29. See H.R. Rep. No. 920, 81st Cong., 1st Sess. 4 (1949), reprinted in 1949-2 C.B. 285, 287.

30. Id. The 1942 Act, oddly enough, provided that the amount distributed was to be taxed to the distributee "as if it were an annuity."

31. See Revenue Act of 1959, Pub. L. No. 183, §335, 65 Stat. 452; Act of July 17, 1952, ch. 942, §1, 66 Stat. 766.

32. See Revenue Act of 1954, ch. 736, §§401-404 and §421, 68 Stat. 1, 134.

33. For an analysis of the legislative changes that have been made to the 1954 Code in the area of pensions, see generally Goodman, Legislative Development of the Federal Tax Treatment of Pension and Profit-Sharing Plans, 49 Taxes 226 (1971) (pre-ERISA); Legislative History of the Employee Retirement Income Security Act of 1974 (Comm. Print 1976) (ERISA); Tax Mgmt. Portfolio BNA No. 314 (1976) (post-ERISA).

34. The Employee Retirement Income Security Act of 1974 [ERISA], Pub. L. No. 93-406, 88 Stat. 829.

35. The Pension Equity Tax Act H.R. 6410 would have used standards similar to the current §410 anti-discrimination standards for qualification of all employee benefit plans. See P-H 1982 Fed. Taxes ¶60,247. The only part of this anti-discrimination proposal that survived in TEFRA was an amendment to §79. See note , _infra_.

36. The Tax Equity and Fiscal Responsibility Tax Act of 1982 [TEFRA], Pub. L. No. 97-248, 96 Stat. 323.

37. See, e.g. Surrey, The Tax Reform Act of 1969 - Tax Deferral and Tax Shelters, 12 B.C. Ind. & Com. L. Rev. 307 (1971).

38. It was held in Manomet Cranberry Co. v. Comm'r., 1 B.T.A 706 (1925) that an ordinary arm's length purchase would not result in the receipt of income even though it could be shown that the property acquired was worth more than the price paid. See also Hurley v. Comm'r,

1966 Tax Ct. Mem. Dec. (P-H) ¶66,066. In 1923 the Treasury attempted for the first time to tax the bargain element in a sale by a corporation to a shareholder as a dividend and that in a sale by an employer to an employee as compensation. See T.D. 3435, II-1 C.B. 50 (1923). With regard to the dividend issue, the Supreme Court in Palmer v. Comm'r, 302 U.S. 63 (1937), held that the bargain element of a shareholder purchase of corporate assets had to constitute a distribution of earnings in order to be a dividend. This holding tends to support the analysis used in the employee stock purchase area that the bargain element must be intended to be compensatory.

39. Geeseman v. Comm'r, 38 B.T.A. 258, 263 (1938).

40. Id. at 265.

41. 1939-1 C.B. 13.

42. See Treas. Regs. 101, Article 22(a)-1 (1939) and T.D. 4879, 1939-1 C.B. 159, amending the same article of Treas. Regs. 86 (1934) and 94 (1936).

43. See Regulation 33 (Revised), Article 4, §21, 16 Treas. Dec. Int. Rev. 22 (1918).

44. Comm'r v. Smith, 324 U.S. 177, dec. on reh"g, 324 U.S. 695 (1945). This holding was in accordance with Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929) (holding payment of an employee's tax liability by an employer to constitute income).

45. See Smith, 324 U.S. at 181.

46. See Smith, 324 U.S. at 695. Under the Smith facts, the initial "exercise" did not effectively pass title to the stock to the taxpayer, and so the Tax Court had held that the time for taxing the

income was in the year in which the stock was delivered. The Treasury had originally published a ruling in 1938 which adopted the time for taxation as being the time of exercise and the amount subjected to tax as being the "spread" in 1938. See I.T. 3204, 1938-2 C.B. 126.

47. T.D. 5507, 1946-1 C.B. 18 and I.T. 3795, 1946-1 C.B. 15. The Tax Court nonetheless felt compelled to continue to distinguish between proprietary and compensatory options. See, e.g., Lo Bue v. Comm'r, 22 T.C. 440 (1954); Rosenberg v. Comm'r, 20 T.C. 5 (1953); Nicolson v. Comm'r, 13 T.C. 690 (1949).

48. Comm'r v. Lo Bue, 351 U.S. 243 (1956).

49. Revenue Act of 1950, ch. 994, §218, 64 Stat. 906. In its report on the amendments creating "restricted" stock option plans, the Senate Finance Committee noted its disagreement with the Treasury's application of the Smith rule on all stock options, whether or not they were "proprietary." See S. Rep. No. 2375, 81st Cong., 2d Sess. 59 (1950), reprinted in 1950 U.S. Code Cong. & Ad. News 3053, 3155.

50. Revenue Act of 1964, Pub. L. No. 88-272, §221(a), 78 Stat. 19; Old §421 was renumbered §424 in the process.

For an analysis of the similarities and differences between "restricted" and "qualified" stock option plans, see Baker, Employee Stock Option Plans Under the Revenue Act of 1964, 20 Tax. L. Rev. 77 (1964).

51. This case also ended the proprietary- compensatory dispute: "In our view there is no statutory basis for the test established by the court below. When assets are transferred by an employer to an employee to secure better services they are plainly compensation." See Lo Bue, 351 U.S. at 247.

52. Kuchman v. Comm'r, 18 T.C. 154 (1952), acq. 1952-2 C.B. 2.

53. Lehman v. Comm'r, 17 T.C. 652 (1951), acq. on this issue withdrawn and nonacq. substituted, 1962-1 C.B. 7. The Tax Court belatedly overruled Lehman in Lighthill v. Comm'r, 66 T.C. 940 (1976).

54. See Treas. Reg. §1.42-6(d) (stock options) and §1.61-2(d)(5) (restricted property), promulgated by T.D. 6416, 1959-2 C.B. 126.

55. 38 Fed. Reg. 15870 (1968).

56. See text at notes , *infra*.

57. See S. Rep. No. 552, 91st Cong., 1st Sess. 120, reprinted in 1969-3 C.B. 423, 500.

58. See I.R.C. §422(b) defining a qualified stock option as one which must be granted on or before May 20, 1976.

59. See Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 152 (1976), reprinted in 1976-3 (Vol. 2) C.B. 1,165. The regulations under I.R.C. §83 were appropriately amended. See Treas. Reg. §1.83-7, adopted July 24, 1978.

60. Cf. Pomeroy, The Metamorphosis of the Nonqualified Stock Option Under the Tax Reform Act of 1976--The Strange Case of the Disappearing Loophole, 54 Taxes 761 (1976) which criticizes Congress for not explicitly changing the law.

61. See I.R.C. §422A(c), added by Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §251, 45 Stat. 172, 256.

62. Revenue Act of 1964, Pub. L. No. 88-272, §423, 78 Stat. 19, 67.

63. See Joint Committee, Tax Expenditure Estimates, *supra* note 7 at 703.

64. See T.D. 2040, 16 Treas. Dec. Int. Rev. 259, 267-268 (1914).

65. See Regulations 33 (Revised), Article 137, 16 Treas. Dec. Int. Rev. 73 (1918) (no deduction as no services had been rendered by the widow or the heirs).

66. See Regulations 45, Article 108, 21 Treas. Dec. Int. Rev. 204 (1919) allowing the deduction.

67. See O.D. 1017, 5 C.B. 101 (1921).

68. See I.T. 3329, 1939-2 C.B. 153, holding that the payment under a resolution worded as was the one quoted therein was deductible as a business expense and reiterating the position regarding gift treatment to the widow taken in O.D. 1017, supra note 29.

69. See, e.g., Louise K. Aprill v. Comm'r, 13 T.C. 707 (1949) acq. 1950-2 C.B. 1 (as to pre-1950 cases); Brayton v. Welch, 39 F. Supp. 537 (D. Mass. 1941).

70. See I.T. 4027, 1950-2 C.B. 9, 10.

71. See MacFarlane v. Comm'r, 19 T.C. 9 (1952); Estate of Hellstrom v. Comm'r, 14 T.C. 916 (1955); Estate of Foote v. Comm'r, 28 T.C. 347 (1957); Luntz v. Comm'r, 29 T.C. 647 (1958). See also Rodner v. United States, 149 F. Supp. 233 (S.D.N.Y. 1957). These cases are discussed in detail in Pelisek, Tax Treatment of Payments to the Widows of Corporate Officers and Employees, 44 Marquette L. Rev. 16 (1960) and Crown, Payments to Corporate Executives' Widows, 19th Annual N.Y.U. Institute on Federal Taxation 815 (1961).

72. Section 302, Revenue Act of 1951, ch. 521, 65 Stat. 452, 453 (amending §22(b)(1) of the 1939 Code).

73. See S. Rep. No. 781, 82d Cong., 1st Sess. 50, reprinted in 1951 U.S. Code Cong. & Ad. News, 1969, 2020-2021.

74. See Poyner v. Comm'r, 301 F.2d 287 (4th Cir. 1962) (allegation of gift intention by the payor possible on the facts; Tax Court decision vacated and proceeding remanded) and Loewy Drug Co. v. United States, 356 F.2d 926 (4th Cir. 1966) (corporate payor denied deduction because of concession that the payment was a gift and that there was no corporate benefit involved). Cf. Fifth Avenue Coach Lines, Inc. v. Comm'r, 31 T.C. 1080 (1959), rev'd on other grounds, 281 F.2d 556 (2d Cir. 1960), cert. denied 366 U.S. 964 (1961) (deduction allowed even though gift treatment to the recipient possible); Bank of Palm Beach & Trust Co. v. United States, 476 F.2d 1343 (Ct.Cl. 1960) (payments to deceased employee's widow deductible under §162 even though gifted to widow; Weyenberg Shoe Mfg. v. Comm'r, 1964 Tax Ct. Mem. Dec. (P-H) ¶64-2204 (gift treatment to widow does not of itself prohibit §162 deduction.

75. See U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Industry, 1980, p. 3. ("Almost all of the workers covered by the survey were provided health insurance.")

76. See Revenue Act of 1918, ch. 18, §213(b)(6), 40 Stat. 1057, 1066.

77. See Regulations 45, Article 33, 21 Treas. Dec. Int. Rev. 180 (1919). "Premiums paid by an employer on life, accident or health policies in favor of his employees as additional compensation of such employees are income to the employees."

78. Revenue Act of 1918, ch. 18, §213(b)(6), 40 Stat. 1057, 1066.

79. See Regulations 33 (Revised), Article 136, 16 Treas. Dec. Int. Rev. 73 (1918). The same rule was found in Regulations 45, Article

108, 21 Treas. Dec. Int. Rev. 204, which was promulgated subsequent to the enactment of the statute.

80. See G.C.M. 23511, 1943 C.B. 86. For a general discussion of pre-1954 plans see Note, Taxation of Employee Accident and Health Plans Before and Under the 1954 Code, 64 Yale Law J. 222, 223-227 (1954).

81. See Rev. Rul. 209, 1953-2 C.B. 104; Rev. Rul 103, 1953-1 C.B. 20.

82. See I.R.C. §105(b).

83. The provision about employee spouse and dependent expenses was added in 1954.

84. I.R.C. §104 also contains other exclusion subsections which will be discussed later.

85. It also clearly provides an exclusion for amounts paid that are attributable to taxed employer contributions. See H.R. Rep. No. 1337, 83d Cong., 2d Sess., reprinted in 1954 U.S. Code Cong. & Ad. News, Vol. 3, 4017, 4169.

86. Id.

87. Id.

88. Confusion had come about because the IRS was litigating the position that an employer-created and funded plan was not covered by the language "accident or health insurance." The Seventh Circuit had disagreed with the strict IRS reading of the statute in Epmeier v. United States, 199 F.2d 508 (7th Cir. 1952) although it made clear that features of an insurance arrangement were required. The Epmeier court's position was later sustained by the Supreme Court but subsequent to the enactment of §105. See Haynes v. United States, 353 U.S. 1 (1957).

89. The 1954 statute provided an exclusion for wage continuation plan payments ("sick pay") that was far broader than that currently available under §105(d). See Internal Revenue Code of 1954, ch. 736, §105(d), 68A Stat.31.

90. See Social Security Amendments of 1983, Pub. L. No. 98-21, §122(b), (d), 97 Stat. 65, 87.

91. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §202, 96 Stat. 323, 421 [TEFRA] [amending I.R.C. §213(a)].

92. See Rev. Rul. 58-602, 1958-2 C.B. 109; Rev. Rul. 73-155, 1973-1 C.B. 50.

93. See I.R.C. §105(c). This exclusion is clearly very limited, but in the instances in which it applies, the coverage is comprehensive. To the extent that job-related injuries are involved, the exclusion may be entirely rational in that it may cover the same ground as the workers' compensation exclusion of §104(a)(1). Cf. Ltr. Rul. 8229094, (April 22, 1982) (payment by county of full salary and medical and hospital bills for police, firefighters, etc. for injuries which occurred in connection with employment is excludable in its entirety).

94. See I.R.C. §105(d) and Prop. Reg. §1.105-7 through 1.105-9, 45 Fed. Reg. 46087-46092 (1980).

95. These are not particularly prevalent as fringes and are treated by the Labor Department as one of the miscellaneous category. See Employee Benefits in Industry, *supra*, note at 30-31. An exclusion for such on-site medical treatment as a working condition is available under Prop. Reg. §1.61-18(d) Example (1) P-H 1983 Fed. Taxes ¶70,181 at 70,182.1.

96. The provision of on-site medical care may well involve condition of employment characteristics to such an extent that treatment as a fringe benefit does not seem appropriate. That would certainly be true with respect to industries which involve serious hazards at the worksite. Also, because such onsite medical treatment may be available as a direct result of requirements imposed by OSHA [The Occupational Safety and Health Act of 1970, 29 U.S.C. §651 et seq. (1976)], the extent to which there is a "fringe" is diminished.

97. See S. 640 introduced by Senator Dole at the request of the Reagan Administration which would impose such a cap for tax years beginning in 1984. The proposed limits would be $175 per month for family coverage and $70 per month for individuals. In testimony before the Senate Finance Committee on June 22, 1983, Assistant Secretary of the Treasury Chapoton spoke in favor of the proposal. He also indicated that the Administration favors an even more significant cut in the benefit in order to fund health insurance for the unemployed. It was estimated that a reduction in the limits to $169 and $68 would raise $300-$400 million in additional revenue to be used for that purpose.

98. See Revenue Act of 1921, ch. 136, §213(b)(11), 42 Stat. 227, 239.

99. See O.D. 862, 4 C.B. 85 (1921).

100. See text at notes , _infra_.

101. One wonders, however, about the truth of the last phrase when one considers the current tuition tax credit legislation pending in Congress which bears a closer resemblance to the N.Y. state law struck down in Committee for Public Education v. Nyquist, 413 U.S. 756 (1973) than to the law upheld in Mueller v. Allen, _____ U.S. _____ (6/29/83).

102. See 1954 U.S. Code Cong. & Ad. News, _supra_ note _____, at 4040.

103. See Boyer v. Comm'r, 69 T.C. 521 (1977); Eden v. Comm'r, 41 T.C. 405 (1964) (undesignated salary payments).

104. See Kirk v. Comm'r, 425 F.2d 492 (D.C. Cir.), cert. denied, 400 U.S. 853 (1970) (no functions of a sacerdotal character performed); Toavs, et al. v. Comm'r, 67 T.C. 897 (1977) (ordained minister performing services for religious-affiliated nonprofit organization not entitled to exclusion because that organization was not a church); Colbert v. Comm'r, 61 T.C. 449 (1974) (nonreligious organization paid a baptist minister an allowance, but the services he performed did not constitute religious worship); Lawrence v. Comm'r, 50 T.C. 494 (1968) (the ordained baptist minister did not perform religious "ordinances" and was thus not a minister of the gospel).

105. See text at note _infra_.

106. See T.D. 2079, 16 Treas. Dec. Int. Rev. 249 (1914).

107. _Id_.

108. _Id_. at 250. Employer reimbursements of employee business expenses are discussed in text at _infra_.

109. See T.D. 2090, 16 Treas. Dec. Int. Rev. 259, 263 (1914).

110. Tennant v. Smith, 111 Tax Cas. 158 (H.L. 1892).

111. See, e.g., Jones v. United States, 60 Ct.Cl. 552, 575 (1925); Benaglia v. Comm'r, 36 B.T.A. 838, 840 (1937), (rev'd by the Board).

112. See Lord Macnaghten in Tennant v. Smith, 111 Tax Cas. at 170-171: "I do not doubt that the occupation of the bank house rent free, though not unattended with some inconveniences, is on the whole a considerable advantage to the Appellant. It is a gain to him in the

popular sense of the word. . . . But a person is chargeable for Income Tax . . . not on what he saves his pocket, but on what goes into his pocket. And the benefit which the Appellant derives from having a rent-free house provided for him by the bank brings in nothing which can be reckoned up as a receipt, or properly described an income."

113. See Regulations 33 (Revised), Article 4, 16 Treas. Dec. Int. Rev. 38 (1918).

114. See O.D. 265, 1 C.B. 71 (1919). It is interesting to note that the analogy was drawn to shipmasters and their cabins in Lord Hannen's opinion in Tennant v. Smith, 111 Tax Cas. at 172.

115. See O.D. 11, 1 C.B. 66 (1919).

116. See O.D. 514, 2 C.B. 90 (1920). It was also stated in the ruling that the payment for supper money was not "charged to the salary account."

117. See Prop. Reg. §1.61-18(d), Example 5, P-H 1983 Fed. Taxes ¶70,181 at 70,182.2.

118. See Treas. Dec. 2992, 2 C.B. 76 (1920), modifying Regulations 45, Art. 33.

119. Id.

120. See O.D. 925, 4 C.B. 85 (1921).

121. See O.D. 814, 4 C.B. 84 (1921).

122. See O.D. 862, 4 C.B. 85 (1921).

123. See O.D. 921, 4 C.B. 86 (1921).

124. See O.D. 914, 4 C.B. 85 (1921).

125. See O.D. 874, 4 C.B. 348 (1921).

126. 60 Ct. Cl. 552 (1925).

127. Id. at 575.

128. Id. at 575-576.

129. Id. at 574. The Service seems now to have completely accepted the application of §119 to armed services personnel including civilians. See Rev. Rul. 71-267, 1971-1 C.B. 37.

130. See also, Diamond v. Sturr, 221 F.2d 264 (2d Cir. 1955) (value of meals and lodging held not taxable despite state law characterization of them as compensation).

131. Benaglia v. Comm'r, 36 B.T.A. 838 (1937) (rev'd by the Board).

132. Van Rosen v. Comm'r, 17 T.C. 834 (1951), (rev'd by the Court).

133. Id. at 838.

134. Id.

135. Mim. 6472, 1950-1 C.B. 15. This Mimeograph was echoed in a Tax Court decision issued in 1953, Doran v. Comm'r, 21 T.C. 374 (1953), where the state employer's characterization of the item as compensatory was held to be determinative, despite the fact that the taxpayer was on 24-hour call. That Congress, in enacting §119, affirmatively decided to reject any reliance on the employer's classification as determinative is clear in the legislative history. See S. Rep. No. 1622, 83d Cong., 2d Sess. 19 (1954), discussed in Comm'r v. Kowalski, 434 U.S. 77, 91-93 (1977). See also Treas. Reg. §1.119-1(a)(1) (as to meals) which applies the statutory and regulatory tests "irrespective of whether under an employment contract or a statute fixing the terms of employment such meals are furnished as compensation." Cf. Treas.. Regs. §1.119-1(b).

136. Comm'r v. Kowalski, 434 U.S. 77, 93 (1977); see also id. at 90-91. For a general discussion of the confusion in pre-1954 law on this subject, see Comment, Tax Treatment of Compensation in Kind, 37 Calif. L. Rev. 628 (1949).

137. See, e.g., Benninghoff v. Comm'r, 71 T.C. 216 (1978), aff'd 614 F.2d 398 (5th Cir. 1980); Adams v. United States, 77-2 U.S.T.C. §9613 (Ct.Cl. 1977); Lindeman v. Comm'r, 60 T.C. 609 (1973); United States Junior Chamber of Commerce v. United States, 334 F.2d 660 (Ct.Cl. 1964); Dole v. Comm'r, 43 T.C. 697, aff'd per curiam 351 F.2d 308 (1st Cir. 1965); Frensley v. Comm'r, Tax Ct. Mem. Dec. (P.H.) ¶82,399.

As to state troopers, the definition of business premises is not clear. See United States v. Barrett, 321 F.2d 911 (5th Cir. 1963) (every road and highway, and evidently adjacent restaurants as well, constitute the business premises of the employer, the state). Accord, United States v. Keeton, 383 F.2d 429 (10th Cir. 1967); United States v. Morelan, 356 F.2d 199 (8th Cir. 1966). But see, Wilson v. United States, 412 F.2d 694 (1st Cir. 1969) (holding that highway roadside restaurants are not "business premises" of the state).

Cf. §119(c) added by the Economic Recovery Tax Act of 1981 supra note ______, 95 Stat. at 195, to clarify the meaning of business premises with respect to overseas camps.

138. Kowalski, supra note , at 94-95. Cf. Coombs v. Comm'r, 67 T.C. 426 (1976) (cash allowance excludable if paid for the express purpose of providing employees with meals at their worksites).

139. See Sibla v. Comm'r, 611 F.2d 1260 (9th Cir. 1980) aff'g 67 T.C. 870 (1977) and 68 T.C. 422 (1977) (firemen's share of meal expenses

excludable under §119); Jacob v. Comm'r, 493 F.2d 1294 (3d Cir. 1974) (value of groceries furnished free to medical institute director held excludable). But see Tougher v. Comm'r, 51 T.C. 737 (1969), aff'd per curiam 441 F.2d 1148 (9th Cir.), cert. denied, 404 U.S. 856 (1971) (grocery allowance not excludable); Rev. Rul. 77-80, 1977-1 C.B. 36 (allowance with which meals are prepared at home not excludable).

General discussions of §119 as it currently exists may be found in Kragen and Speer, I.R.C. §119: Is Convenience of the Employer a Valid Concept?, 29 Hastings L.J. 921 (1974); Note, A New Look at the Section 119 Meals and Lodging Exclusion, 81 W.Va. L. Rev. 483 (1979); Note, Meal Reimbursements as an Employee Fringe Benefit, 10 Loy.U. Chi. L.J. 789 (1979).

140. See Rowan Cos. v. United States, 452 U.S. 247 (1981). The Rowan result was codified by the Social Security Act Amendments of 1983, H.R. 1900, 98th Cong., 1st Sess., §330, amending I.R.C. §3121. The question of whether fringes should be treated differently for income tax and for payroll tax purposes is discussed in Richmond, supra note 4.

141. See 42 Fed. Reg. 43,059-43,061 (1977); 43 Fed. Reg. 6060-6065 (1978).

142. Tax Treatment Extension Act of 1977, Pub. L. No. 95-665, §205, 92 Stat. 3097, 3107 (amendment effective for taxable years beginning after December 31, 1977).

143. Compare Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1958) (remand required to determine if taxpayer's spouse and child were also employees) with Coyner v. Bingler, 344 F.2d 736 (3d Cir. 1965) (employee and wife required to live in building; exclusion allowed for the entire

value of housing). The first published position of the Service with regard to spouse and dependent portions of the value of housing was found in Rev. Rul. 59-409, 1959-2 C.B. 48, where it was held that the value of meals and lodging supplied by a school to the employee's families was includable in the employees' income, but without explanation only one year later, the ruling was revoked. See Rev. Rul. 60-348, 1960-2 C.B. 41.

144. The roots are reflected in the language of §119 as it relates to lodging. Section 119(a)(2) requires that the employee be required to accept the lodging "as a condition of his employment" in order for the exclusion to be available.

145. See, e.g., Adams v. United States, 77-2 U.S.T.C.¶9613 (Ct.Cl. 1977) (fair rental value of "prestigious" house furnished by employer to executive employee living in Japan excludable under §119 because it was necessary for the employee to live in plush surroundings in order to be effective in conducting business in Japan; some business conducted in home).

146. See Part III.A.1. infra.

147. See Ltr. Rul. 8213005 (December 21, 1982) in which the Service held that the differential between rents charged university employees and the fair rental value of the university owned housing was includable in the employee's income and also constituted wages for purposes of FICA and FUTA. This ruling caused quite an uproar and resulted in the introduction of legislation to make it clear that the fringe benefit moratorium, supra, note applied to these items. See letter of September 22, 1982 from Sen. John Heinz to Commissioner of

Internal Revenue Roscoe Egger referring to S. 2871, introduced by Senators Heinz and Moynihan, quoted in 17 Tax Notes 319 (October 25, 1982).

It is surprising in some ways that the well-established authority for the position of the Service is so systematically ignored by the politicians. See, e.g., Goldsboro Christian Schools v. United States, 436 F. Supp. 1314 (E.D.N.C. 1977), aff'd on other grounds on motion for reconsideration, 43 A.F.T.R.2d (P-H) 79-868 (E.D.N.C. 1978), aff'd by unpublished order (4th Cir. 1981); Bob Jones University v. United States, 670 F.2d 167 (Ct.Cl. 1982). In both of these cases the §119 exclusion was unavailable mainly because the employees were not on twenty-four hour call and that the homes were not actually part of the business premises.

148. The exclusion presently codified as §112 originated in the Revenue Act of 1945, ch. 453, §141, 59 Stat. 556, 571 (formerly I.R.C. §22(b) (13) (1939)). Section 113 refers to payments made pursuant to the Mustering-Out Payment Act of 1944, ch. 9, 58 Stat. 8, 9.

149. An area is considered to be a combat zone if it is so designated in an Executive Order by the President. See §112(c) (2). Treas. Reg. §1.112-1(j) provides that activities performed outside a combat zone are deemed to be performed in the combat zone if in direct support of military activities in such a zone.

150. The hospitalization period may not extend more than two years after the cessation of combat activity in the combat zone in which the injury, etc. occurred. See §112(a) (2).

151. Enlisted men and noncommissioned officers may exclude all of their compensation under §112(a), while commissioned officers are entitled to an exclusion of only up to $500 per month under §112(b). This distinction has been held constitutional as not violative of equal protection principles in Bruinooge v. United States, 550 F.2d 624 (Ct.Cl. 1977).

152. "Missing" is defined in 37 U.S.C. §551(2) (1976) and generally means a person who is a prisoner of war or missing in action.

153. Mustering-out payments are defined by Treas. Reg. §1.113-1 as those payments made pursuant to 38 U.S.C. §2105 (Act of September 2, 1958, Pub. L. No. 85-857, 72 Stat. 1105, 1224), formerly section 5 of the Mustering-Out Payment Act of 1944, ch. 9, 58 Stat. 8, 9, and section 505 of the Veterans Readjustment Assistance Act of 1952, ch. 875, 66 Stat. 663, 690. It is interesting to note that 38 U.S.C. §2105 was repealed by an Act of June 24, 1965, Pub. L. No. 89-50, 79 Stat. 173 and that the regulations have not been amended to provide some other definition.

154. See 1975 Discussion Draft, *supra* note 14.

155. Revenue Act of 1964, Pub. L. No. 88-272, §204(a), 78 Stat. 19, 36.

156. Treas. Reg. §1.79-3(a) (b) and (e).

157. See I.R.C. §79(d).

158. See Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA], Pub. L. No. 97-248, §244, 96 Stat. 323, 523.

159. See Sol. Op. 1014, 2 C.B. 88 (1920). See also R. Paul and J. Mertens, Federal Income Taxation ¶7.05.

160. See T.D. 2992, 22 Treas. Dec. Int. Rev. 233, reprinted in 2 C.B. 76 (1920).

161. In other words, the T.D. 2992 exclusion was for all premiums, regardless of the amount of insurance they bought. It did not, however, include "group permanent" life insurance premiums. See Mim. 6477, 1950-1 C.B. 16.

162. I.R.C. §120 was enacted by the Tax Reform Act of 1976, Pub. L. No. 94-455, §2134, 90 Stat. 1520, 1926. For the legislative history of the section, see Joint Comm. Explanation of Tax Reform Act of 1976, H.R. 10612, 94th Cong. 2d Sess. 668, reprinted in 1976-3 C.B. (Vol. 2) 680 and S. Rep. 94-1236, 94th Cong., 2d Sess. 537, reprinted in 1976-3 C.B. (Vol. 3), 940.

163. See Macauley, *supra* note 2 at .

164. See I.R.C. §120(e) as originally enacted, Tax Reform Act of 1976, Pub. L. No. 94-455, §2134, 90 Stat. 1520, 1928.

165. See Pub. L. No. 97-34, §802, 95 Stat. 172, 349.

166. See I.R.C. §120(a) and Prop. Treas. Reg. §1.120-1(a), P-H 1983 Fed. Taxes ¶8703.4.

167. See I.R.C. §120(c) and Prop. Reg. §1.120-2, P-H 1983 Fed. Taxes ¶8703.5.

168. See Prop. Reg. §1.120-3, P-H 1983 Fed. Taxes ¶8703.6.

169. Pub. L. No. 95-618, §242, 92 Stat. 3174, 3193.

170. See I.R.C. §124(b).

171. See Joint Explanatory Statement of the Conf. Comm., 95th Cong., 2d Sess., 53-54, reprinted in 1978 U.S. Code Cong. & Ad. News 8071, 8082-8083.

172. See Joint Comm. on Internal Revenue Taxation, Examination of President Nixon's Tax Returns for 1969 through 1972, H. Rep. No. 966, 93d Cong., 2d Sess. 159 (1974).

173. Revenue Act of 1978, Pub. L. No. 95-600, §134, 92 Stat. 2763, 2783.

174. See I.R.C. §125(d) (2) (as amended by the Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, 94 Stat. 3521, 3529).

175. See generally I.R.C. §125(f). The benefits available include legal services benefits, "qualified transportation," educational assistance, health benefits, etc. See S. Rep. No. 1263, 95th Cong., 2d Sess. 74, reprinted in 1978 U.S. Code Cong. & Ad. News 6761, 6837.

176. See I.R.C. §125(c). The Treasury has not yet issued regulations under the authority of §125(b) to describe the nondiscrimination requirements and other aspects of cafeteria plan qualification. It is not clear when regulations under the section will be forthcoming. See Daily Tax Report (BNA), at G-2 (April 19, 1983).

177. See I.R.C. §125(g) (2).

178. See I.R.C. §125(g) (1).

179. See I.R.C. §125(b).

180. The revenue loss from the widespread use of cafeteria plans could well be "monstrous," to use the words of Arthur Kroll at a recent Practicing Law Institute in New York. See Daily Tax Report (BNA), at G-3, G-4 (April 29, 1983)[hereinafter cited as April PLI].

181. See remarks of Lawrence Sader, April PLI supra note at G-4.

182. See remarks of Kroll, April PLI, supra note at G-4.

183. See Chapoton testimony supra note .

184. See remarks of Professor Daniel Halperin at Employee Benefits Research Institute, noted in Daily Tax Report (BNA), at G-4, G-5 (June 9, 1983).

185. For a general discussion of educational assistance plans, see Caplin, 57 Taxes 75 (1979).

186. See I.R.C. §127(b) (2).

187. See Armantrout v. Commissioner, 67 T.C. 996 (1977), aff'd per curiam, 570 F.2d 210 (7th Cir. 1978).

188. See Treas. Reg. §1.117-3 discussed in text at p. , _supra_.

189. See I.R.C. §127(c).

190. See Treas. Reg. §1.127-2(c) (3) (iii).

191. See I.R.C. §127(b) (4).

192. See I.R.C. §127(b) (2) and Treas. Reg. §1.127-2(e).

193. See Treas. Reg. §1.127-2(e) (2) (ii).

194. See Treas. Reg. §1.127-2(e).

195. See I.R.C. §127(c) (1).

196. See S. 249, "Employee Educational Assistance Extension Act," 98th Cong., 1st Sess. (1983).

197. See statement by William S. McKee, Acting Deputy Assistant Secretary for the Treasury for Tax Policy, at Hearing on April 29, 1983, by Senate Finance Committee Subcommittee on Taxation and Debt Management, Daily Tax Report (BNA) at J-8 (April 29, 1983).

198. Economic Recovery Tax Act of 1981 [ERTA], P.L. 97-34, §124(e), 95 Stat. 172, 198.

199. These include expenses for household services and for actual cost of a dependent person. They also include expenses incurred at a dependent care center. See §44A(c) (2).

200. See §129(d) (2).

201. See §129(d) (6).

202. See §129(c) (2).

203. See §129(b).

204. See §44A(d).

205. O.D. 514, 2 C.B. 90 (1920). Whether this rule can survive the Kowalski decision that §119 applies only to in-kind items is questionable.

206. See Prop. Reg. §1.61-18(d) (5), P-H 1983 Fed. Taxes ¶70,181 at 70,182.2.

207. See H.R. Rep. 1337, 83d Cong., 2d Sess. reprinted in 1954 U.S. Code Cong. & Ad. News 4017, 4173.

208. Treas. Reg. §1.117-3(a).

209. The proposed fringe benefit regulations would amend the §1.117-3 language cited in note 203, but only to provide that such amounts are treated as scholarships until a certain date. See Prop. Reg. §1.117-3, P-H 1983 Fed. Taxes ¶70,181 at 70,182.5. That is not the proper thrust of the repeal of the tuition remission exclusion. The focus should be on the fact that the payments are to be treated as scholarships as to the children or dependents but not as to the employee with respect to whose work they are made.

210. See 41 Fed. Reg. 48,132-48,133 (1976).

211. See 42 Fed. Reg. 3181 (1977).

212. See Prop. Reg. §1.117-3(a), P-H 1983 Fed. Taxes ¶70,181 at 70,182.5.

213. See note supra.

214. See Armantrout v. Commissioner, 67 T.C. 996 (1977) aff'd per curiam, 570 F.2d 210 (7th Cir. 1978) and the other educational benefit trust cases cited in note infra.

215. See the discussion of employee discounts in text of note____, infra and the examples in Part II, infra, pp. .

216. See Prop. Reg. §1.61-19-1(b)(1), P-H 1983 Fed. Taxes ¶70,181 at 70,182.3. The discount must be available to all employees in a nondiscriminatory fashion and must not exceed certain specified amounts.

217. See I.R.C. §3101(a).

218. See I.R.C. §3111(a).

219. See Rev. Rul. 80-164, 1980-1 C.B. 109 and Rev. Rul. 74-40, 1974-1 C.B. 116 regarding the timing of the deduction for such items and also for FUTA taxes.

220. See I.R.C. §3102(a).

221. See Summers v. Comm'r, 1971 Tax Ct. Mem. Dec. (P-H) ¶71,011; Escofil v. Comm'r, 1971 Tax Ct. Mem. Dec. (P-H) ¶71,131 aff'd per curiam 464 F.2d 358 (3d Cir. 1972).

222. See 42 U.S.C. §430(c) (1983 supplement).

223. See I.R.C. §1401 of the 1954 Code. This tax was added to supplement the FICA tax and extend it to the self-employed. See S.Rep. No. 1669, 81st Cong., 2d Sess. 1950, reprinted in 2 C.B. 302, 307-308.

224. I.R.C. §86 was added by the Social Security Amendments Act of 1983, H.R. 1900, 98th Cong., 1st Sess. §121. Prior to 1983, no portion of social security benefits was subject to tax.

225. Act of August 14, 1935 (Social Security Act), ch. 531, §§801-804, 49 Stat. 620, 636-637. The conclusion that there is no statutory authority for the exclusion is supported by the legislative history of H.R. 1900, the Social Security Amendments Act 1983. See H. Rept. No. 98-25 [1983 P-H Fed. Taxes ¶59,304 at 59,304.23]

226. Revenue Act of 1936, ch. 690, 49 Stat. 1648.

227. Such individuals were those who had attained the retirement age of 65 but had not passed the tests of total wages paid or number of years worked since December 31, 1936. It seems that benefits received by "qualified" persons were not subject to tax in any event.

228. See I.T. 3194, 1938-1 C.B. 114.

229. See I.T. 3229, 1938-2 C.B. 136.

230. See I.T. 3447, 1941-1 C.B. 191.

231. See Rev. Rul. 70-217, 1970-1 C.B. 12.

232. See Rev. Rul. 70-217, supra note . See also Rev. Rul. 57-344, 1957-2 C.B. 112 (survivors' insurance benefits excludable even though they enter into computation of individual's total support for application of 50% test of §151(e) for the dependency exemption).

233. See, e.g., Rev. Rul. 57-102, 1957-1 C.B. 26 (benefits paid to a blind person under state public assistance law excludable); Rev. Rul. 74-153, 1974-1 C.B. 20 (state payments to adoptive parents who use payments for support and maintenance of adopted children excludable since in the nature of general welfare benefits, Rev. Rul. 78-170, 1978-1 C.B. 24 (state payments to qualified individuals to reduce cost of winter energy consumption excludable); Rev. Rul 74-74, 1974-1 C.B. 18 (awards made by New York Crime Victims Compensation Board excludable).

234. I.R.C. §86 was added by the Social Security Amendments Act of 1983, H.R. 1900, 98th Cong., 1st Sess. §121. Prior to 1983, no portion of social security benefits was subject to tax.

226a.

235. See §86(a) and (b). The includable amount is one-half of the Social Security benefits or one-half of the amount by which Social Security benefits plus modified AGI exceeds the base amount. The effect of this provision may in some circumstances tax the benefits at a rate exceeding 100%!

236. See I.T. 1293, I-1 C.B. 63 (1922), superseded by Rev. Rul. 71-70, 1971-1 C.B. 27 (to some effect).

237. See I.T. 3230, 1938-2 C.B. 136 (superseded by Rev. Rul. 70-280, 1970-1 C.B. 13).

238. *Id*. at 137.

239. See, e.g., Rev. Rul. 55-562, 1955-2 C.B. 21 (extending I.T. 3230 to benefits paid pursuant to Title XV of the Social Security Act); Rev. Rul. 73-154, 1973-1 C.B. 40 (excluding payments made under the Emergency Unemployment Compensation Act of 1971); Rev. Rul. 76-63, 1976-1 C.B. 14 (excluding payments made under of the Emergency Unemployment Compensation Act of 1974 and Title II of the Emergency Jobs and Unemployment Assistance Act of 1974), and Rev. Rul. 76-229, 1976-1 C.B. 19 (excluding certain payments made under the Trade Act of 1974).

240. If, however, the recipient is being paid a fair market wage under the government program, it is likely that the benefits will be included in income. See rulings cited in note    , *infra*.

241. See, e.g., Rev. Rul. 63-136, 1963-2 C.B. 19 (on-the-job training payments made under the Area Redevelopment Act of 1962 or under the Manpower Development and Training Act of 1962 are excludable since they "are intended to aid the recipients in their efforts to acquire new skills that will enable them to obtain better employment opportunities"); Rev. Rul. 67-144, 1967-1 C.B. 12 (certain welfare payments intended to compensate for services performed by recipient held includable in gross income, otherwise excludable); Rev. Rul. 71-425, 1971-2 C.B. 76 (welfare payments based on personal or familial subsistence requirements not includable in gross income, payments made intended to compensate for services includable); Rev. Rul. 74-413, 1974-2 C.B. 333 (for payments to be excludable, primary purpose of the program must be to train the participants, not to compensate them for work they performed).

242. See Revenue Act of 1978, Pub. L. No. 95-600, §112, 92 Stat. 2763, 2777.

243. The base amount is defined in I.R.C. §85(b). It is generally $12,000 or $16,000 in the case of a joint return. These base amount figures were reduced from $20,000 and $25,000 by TEFRA. See Pub. L. No. 97-248, §611, 96 Stat. 243, 706.

244. See I.R.C. §85(a). This provision was changed from the original which was somewhat more complicated, by amendments in 1981 (Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §103(c) (1), 95 Stat. 172, 188) and 1982 (Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §611, 96 Stat. 243, 706).

245. See H. Rep. No. 1445, 95th Cong., 2d Sess. 48 (1978), reprinted in 1978-3 (Vol. 2) C.B. 181, 222.

246. See Rev. Rul. 75-499, 1975-2 C.B. 43, amplifying Rev. Rul. 72-191, 1972-1 C.B. 45, which superseded Rev. Rul. 257, 1953-2 C.B. 15, and which was modified by Rev. Rul. 81-192, 1981-2 C.B. 50 (nonoccupational employee disability benefits are includable in gross income to the extent that they are attributable to employer contributions that were not included in income of the employee when they were made by the employer).

247. Id. See also Rev. Rul. 79-147, 1979-1 C.B. 80.

248. For a discussion of §104(a) (1) see BITTKER, supra note at ¶13.1.2.

249. See O.D. 946, 4 C.B. 110 (1920). Such passes were considered to be gifts if they were not required to be made available to the employee under the terms of the employment contract.

250. See generally, Greenspun v. Comm'r, 72 T.C. 931 (1979); B. Forman Co. v. Comm'r, 54 T.C. 912 (1970), nonacq., 1975-1 C.B. 2; Dean v. Commissioner, 35 T.C. 1083 (1961), nonacq., 1973-2 C.B. 4.

The position with respect to these items that is found in the 1981 proposed regulation is that under certain circumstances such discounted loans will result in income (e.g. where the borrower "intends" to use the loan funds to purchase tax exempt bonds). See Prop. Reg. §1.61-17(d) Example (5), P-H 1983 Fed. Taxes ¶70,181 at 70,182 In other circumstances, where the borrower "desires" to purchase taxable bonds, a rule of convenience of noninclusion is announced. See Prop. Reg. §1.61-19(c) Example (11), P-H 1983 Fed. Taxes ¶70,181 at 70,182.4.

These standards seem peculiarly inappropriate in the setting where many such loans would occur, the small corporation. Additionally, suppose the borrower changes her mind after two months? Also, there is no standard to be applied to borrowing for personal, nonincome-producing purposes. This type of borrowing is typical of many low-interest loans for employees of large companies and institutions which are available only on a discriminatory basis. See, e.g., the low-interest home mortgage loan program of the University of California (available only for certain faculty), on file in the author's office at U.C.L.A.

The appropriate standard ought to be that the value of the discount will be included in the income of the employee who receives it. This should be the rule regardless of the choice of item purchased with the borrowed funds. The fact that the borrower might or might not be entitled to an interest deduction in the full amount of the interest "paid" to the employer is not relevant to the income-inclusion issue. There is no other way to give proper effect to I.R.C. §163(d) (limitation on investment interest) and §265(2) (nondeductibility of interest incurred to purchase or carry tax exempt bonds).

251. See Part II.B. Example 1, infra p. .

252. See Regulations 33 (Revised), Article 4, §§21, 22, 20 Treas. Dec. Int. Rev. 130 (1918).

253. These items were not mentioned specifically in any ruling, but the IRS policy of excluding them from income was clear. See I.R.S. Pub. No. 17, Your Income Tax 36, cited in BITTKER, supra note at 14-6, note 16.

254. The policy of exclusion for employee discounts which are small, repetitive and available to all employees on a nondiscriminatory basis was continued in 1981 Prop. Reg. §1.61-19(b) (1) and (c) Example (1), P-H 1983 Fed. Taxes ¶70,181 at 70,182.3. See also, 1975 Discussion Draft Prop. Reg. §161-16(f) (3).

255. See cases cited at note , supra.

256. See, e.g., Dole v. Comm'r, 45 T.C. 697, aff'd per curiam, 351 F.2d 308 (1st Cir. 1965); Whipple Chrysler-Plymouth v. Comm'r, 1972 Tax Tax Ct. Mem. Dec. (P-H) ¶72,655; Rodgers Dairy v. Comm'r, 14 T.C. 66 (1950), acq. 1950-2 C.B. 4. Such items may not, however, be wages subject to withholding; see Ltr. Rul. 8122017 (February 24, 1981).

257. See, e.g., Weinberg v. Comm'r, 64 T.C. 771 (1975) (hospital resident); Goldstein v.. Comm'r, 75 T.C. 164 (1979) (Vista volunteer).

258. See, e.g., Gottlieb v. United States, 8 A.F.T.R.2d (P-H) 5475 (E.D.La. 1961) (boat); Standard Motors, Inc. v. United States, 8 A.F.T.R.2d (P-H) 5472 (E.D.La. 1961) (boat).

259. The most vocal objections to the Carter Administration proposals to limit the deductibility of "three-martini" lunches came not from the businessmen whose luncheon styles might be changed but from the restaurant industry.

260. See Treas. Reg. §1.274-5(e) (2).

This exclusion of reimbursed expenses has a long history. See, e.g., T.D. 2079, 16 Treas. Dec. Int. Rev. 249 (1914) allowing an exclusion for reimbursements for officers and employees of the United States.

In addition to going untaxed at the employee level, employer reimbursements do not constitute wages for purposes of withholding, FICA and FUTA. See Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978).

It has been estimated that limiting business entertainment deductions to 50% of the amount spent would raise one-half billion dollars in 1984, $1.1 billion in 1985 and $1.2 billion in 1986. See Democratic Study Group, Alternative Revenue Options, April 14, 1983 Tax Notes 77, 79.

261. See "Business Travel: Amenities Curbed," N.Y. Times, June 15, 1983, at 42, col. 1. The story notes that many executives are now required to fly coach class when they travel on business and that companies are using computers to better track employee tendencies toward lavish expenditures of corporate funds.

262. See H.R. 3525, the "Permanent Tax Treatment of Fringe Benefits Act of 1983," 98th Cong. 1st Sess. (July 12, 1983). The proposal would continue the current system of exclusions and would add new section 132 to the Code to exclude from income "any fringe benefit which qualifies as a--

(1) no- additional- cost service,
(2) qualified employee discount,
(3) working condition fringe, or
(4) de minimis fringe."

In addition, the House bill contains limitations on deductions for recreational facilities furnished to employees unless the employees are required to include in income the value of the benefit of using the recreational facility. See §2(b) of the bill which would add new §280F to the Code.

See also S. 1817, the "Fringe Benefits Tax Act of 1983," 98th Cong., 1st Sess., which would do essentially the same things as would the House bill. In addition, specific provision is made in the Senate bill for educational institutions' programs for tuition remission and housing for employees and their dependents.

263. See proposed §132(g) (4) of the House bill.

264. See H.R. 3525 and S. 1817, discussed in note supra. In 1980 the Tax Section of the American Bar Association passed a Legislative Recommendation which would add new §128 to the Internal Revenue Code to provide for the treatment of current nonstatutory fringe benefits under a comprehensive scheme. Under that proposal the value of "personal service benefits" received by an employee from an employer would not be included in income if:

1. the benefit was incident to the employer's trade or business, the marginal cost of providing the benefit was insubstantial, and the class of employees entitled to receive the benefit was not a discriminatory one;
2. the benefit was provided for the benefit of the employer;
3. the benefit was a recreational, etc. benefit described in I.R.C. §274(e) (5);
4. the benefit was of nominal value (as there defined).

Apart from these provisions, any benefit which is currently a nontaxable, nonstatutory fringe benefit would be subject to tax under I.R.C. §83. See Committee on General Income Tax Problems, Tax Section

Recommendation No. 1980-1, 33 Tax Law. 993, 1005 (1980). The Discussion accompanying the recommendation notes the general agreement of the recommendation with proposals of the American Institute of Certified Public Accountants (AICPA) and a Task Force of the Staff of the Joint Committee on Taxation. Id. at 1002.

The current position of the American Bar Ass'n [ABA] regarding fringe benefit taxation is along the lines of this earlier proposal. See statement of H. Bernard Aidinoff at Hearings on Fringe Benefit Taxation before the Senate Finance Committee, June 22, 1983.

The ABA proposal is obviously at odds with the proposal made in this article. Nevertheless, despite disagreement as to the scope of exclusions from taxable treatment, the ABA proposal does recognize the validity of using current §83 to tax benefits that do not come within the exclusionary provisions. That conclusion is in general agreement with the thesis that is developed more explicitly and in more detail here.

265. I am not alone in suggesting that the prospect of new legislation is an unhappy one. Stanley Surrey, for one, believes the tax legislative process to have "completely disintegrated" and to have come to "utter chaos without responsible control residing anywhere." See Surrey, Our Troubled Tax Policy: False Routes and Proper Paths to Change, 12 Tax Notes 179, 185 (January 2, 1981).

266. See discussion of these matters in text at notes 38a to 60 aupe.

267. See discussion in text at note , infra.

268. See Prop. Reg. §1.61, note ____, supra.

269. Regulation 33 (Revised), Article 4, §§21, 22, 20 Treas. Dec. Int. Rev. 130 (1918). See also Regulation 45, Article 33, 21 Treas. Dec. Int. Rev. 180 (1919): "Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash."

270. Id. at Article 139.

271. See, e.g., Treas. Reg. §1.61-2(d).

272. See text at note , supra.

273. For general discussions of I.R.C. §83, see Asimow, Section 83: A Tale of Four Restrictions, 15 Bev. Hills Bar J. 543 (1981); Metzer, The Receipt of Property for Services, 38 N.Y.U. Inst. on Fed. Tax 24-1 (1980); Baker, Restricted Property--Sec. 83, Tax Mgmt. Portfolio (BNA) No. 262 (1972 with supplementation). For a specific discussion of §83 as it relates to restricted stock, see Johnson, Stock Compensation under Section 83: A Reassessment, 32d So. Cal. Tax Inst. 8-1 (1980).

274. See Treas. Reg. §1.83-3(e).

275. If a taxpayer receives an item of income under claim of right, he is generally required to include it in income at the time of receipt under the doctrine of North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). Application of this doctrine in the compensation area may be found in Healy v. Comm'r, 345 U.S. 278 (1953) and United States v. Lewis, 340 U.S. 590 (1951). A later restoration of the item or a portion thereof will result in a deduction for the taxpayer in the year of repayment or at another appropriate time under his method of accounting. Under certain circumstances, I.R.C. §1341 will operate to

relieve the taxpayer of any disadvantage that may result from the operation of the normal process of inclusion and deduction.

276. Compare Rev. Rul. 68-123, 1968-1 C.B. 35 (member of religious society acting as agent for her order not required to include in income amounts paid for her services by checks endorsed by her to the order) with Rev. Rul. 76-323, 1976-2 C.B. 18 (members of religious orders not acting as agents for orders, held, taxable on wages even though entire amount minus living expenses required to be endorsed over to order).

277. See, e.g., Stevens Bros. & Miller-Hutchinson Co. v. Comm'r, 24 T.C. 953 (1955) (one-half of profits which were received not under contract made payable to another not taxable to contract); Eagleton v. Comm'r, 35 B.T.A. 551 (1937), aff'd on other grounds, 97 F.2d 62 (8th Cir. 1938) (same rule with respect to attorneys fees payable to another lawyer).

278. See, e.g., Rev. Rul. 71-449, 1971-2 C.B. 77 (contributions totaling $1000 received by political candidate for use in campaign; candidate required to include in income $400 of that amount which was diverted to payment of his mortgage in year in which diversion occurred). Cf. Rev. Rul. 74-23, 1974-1 C.B. 17 (no diversion of funds for personal use and therefore no inclusion in income of political candidate).

279. See, e.g., Jackson v. Smietanka, 272 F. 970 (7th Cir. 1921) (right to additional commission did not occur ratably; it was taxable only when paid); Edwards v. Keith, 231 F. 110, 112 (2d Cir. 1916) (renewal commissions for sale of life insurance not taxable until received because "there is no certainty that the sum conditionally promised for an ensuing year will ever be paid. . . .").

280. See Rev. Rul. 60-31, 1960-1 C.B. 174, applying cash accounting principles to prevent current taxation of amount credited to unfunded deferred compensation plans but indicating that the doctrine of constructive receipt must be examined in all such cases. The House attempt to tax currently payments under such deferred compensation arrangements was rejected by the Senate. See S. Rep. No. 552, 91st Cong., 1st Sess. 306-307 (1969), reprinted in 1969-3 C.B. 423, 502. The Internal Revenue Service attempt to tax certain deferrals of this nature which are made at the recipient taxpayer's option in 1975 Discussion Draft, Prop. Reg. §1.61-16 which was blocked by the Revenue Act of 1978, Pub. L. No. 95-600, §132, 92 Stat. 2763, 2782.

281. Compare also Treas. Reg. §1.61-2(d)(4) which provides that notes or other evidences of indebtedness given in payment for services constitute income in the amount of their fair market value. The proposed I.R.C. §83 regulations had specifically provided that notes would be property for I.R.C. §83 purposes (see Prop. Reg. §1.83-3(e) (1971), but were subject to criticism on this account and the final regulations did not include such a provision. See Committee on Taxation, Ass'n of the Bar of the City of N.Y., Comments on Proposed Regulations under §83, 40-41 (1971); N.Y. State Bar Ass'n, Report of the Committee on Employee Benefits on Proposed Regulations Dealing with the Treatment of Property Transferred in Connection with Performance of Services, 4 (1971).

282. See, e.g., Armantrout v. Comm'r, 67 T.C. 996, 1008 (1977), aff'd per curiam, 570 F.2d 210 (7th Cir. 1978) (the parties did not base their arguments in the case on §83 but the court felt compelled to

"point out that our decision is supported by the specific language of section 83. . . ."); Grant-Jacoby Inc. v. Comm'r, 73 T.C. 700, 710 (1980) (the Tax Court said that time of payment was the proper time for taxation "since petitioners did not have vested rights in the contributions made . . . to the trust"). See also Rev. Rul. 75-448, 1975-2 C.B. 55 (holding the amounts paid taxable and the employer's deduction allowable in the year in which tuition is paid). But see Greensboro Pathology Ass'n, v. United States, _____ F.2d _____, 51 A.F.T.R. 2d (P-H) 567 (Fed. Cir. 1983) (amounts contributed to educational benefit plan of corporation currently deductible by corporation because plan resembled those described in Treas. Reg. §1.61-10(a) more than §404(a) plans; the only question presented was the §162 one and not the question of employee excludability; _id_. at , note 3).

The company which administers the plans involved in _Armantrout_ and _Grant-Jacoby_ had sought to enjoin the issuance of the revenue ruling but the suit was held to be barred by the anti-injunction act. See Educo Inc. v. Alexander, 557 F.2d 617 (7th Cir. 1977).

283. Armantrout v. Comm'r, 67 T.C. 996 (1977).

284. Compare Rev. Rul. 80-300, 1980-2 C.B. 165, applying constructive receipt principles to a stock appreciation right (SAR) plan of an employer. An employee would not be taxable upon receipt of the SAR's because they were subject to forfeiture, but she would be taxable upon exercise. Further discussion of this question as it applies specifically to other fringe benefits may be found at p. _____, _infra_.

285. See I.R.C. §402(b) discussed generally in Bittker, supra note at .

286. See Treas. Reg. §1.83-3(c) (4), Example (2). The related question of the timing of the deduction by the employer is considered in Grant-Jacoby, supra, note _____, 73 T.C. at 710-716.

287. Treas. Reg. §1.83-3(a) (1).

288. See Treas. Reg. §1.83-3(a) (6) and (7), Example (5) for definition and example.

289. See Treas. Reg. §1.83-3(a) (4). The Internal Revenue Service has indicated that it will not issue rulings on whether a transfer has occurred for §83 purposes if the amount received for the purported transfer involves a non-recourse obligation. See Rev. Proc. 81-10, 1981-1 C.B. 647. See also Treas. Reg. §1.83-3(a) (7), Example (2).

290. See Treas. Reg. §1.83-3(a) (2).

291. See Treas. Reg. §1.83-3(f).

292. See Cohn v. Comm'r, 73 T.C. 443 (1979); Cassetta v. Comm'r, 1979 Tax Ct. Mem. Dec. (P-H) ¶79,388.

293. See Treas. Reg. §1.83-3(b).

294. See, e.g., Sakol v. Comm'r, 67 T.C. 986 (1977), aff'd, 574 F.2d 694 (2d Cir.) cert. denied, 439 U.S. 859 (1978) where the stock in question was still subject to transfer restrictions after the lapse of a substantial risk of forfeiture, I.R.C. §83 held constitutional.

295. Treas. Reg. §1.83-3(d) which defines transferability says that "property is transferable if the person performing the services or receiving the property can sell, assign or pledge . . . his interest in the property to any person other than the transferor of the property and

if the transferee is not required to give up the property or its value in the event the substantial risk of forfeitable materializes."

296. In 1981 Congress amended I.R.C. §83 by adding paragraph (3) to subsection (c) which provides that

> "[s]o long as the sale of property at a profit could subject a person to suit under section 16(b) of the Securities and Exchange Act of 1934, such person's right in such property are -
> (A) subject to a substantial risk of forfeiture, and
> (B) not transferable."

Economic Recovery Tax Act of 1981 [ERTA], Pub. L. No. 97-34, §252, 95 Stat. 172, 260.

297. Horwith v. Comm'r, 71 T.C. 932, 940 (1979). The right to designate a beneficiary to receive the property in the event of death does not make the property transferable. The effect of a transfer of substantially nonvested property is considered in text at note , *infra*.

298. Richardson v. Comm'r, 64 T.C. 621 (1975).

299. *Id*. at 629. What was to happen to the corpus of the trust consisting of all the previously contributed amounts was not stated in the agreement. *Id*.

300. *Id*. at 630-31. See also Treas. Reg. §1.83-3(c) (2).

301. 64 T.C. at 630, citing S. Rep. No. 552, 91st Cong., 1st Sess. 122-123 (1969), reprinted in 1969-3 C.B. 423, 501-502.

302. Edward L. Burnetta, O.D., P.A., v. Comm'r, 68 T.C.387, 403-405 (1977).

303. *Id*. at 405. See also Treas. Reg. §1.83-3(c)(2).

304. The Internal Revenue Service has announced that it will not issue rulings as to whether a restriction constitutes a substantial risk of forfeiture of the employee is a controlling shareholder of the corporation. See Rev. Proc. 81-10, 1981-1 C.B. 647.

305. See Treas. Reg. §1.83-3(c) (1) and (h) and §1.83-5.

306. See also Ltr. Rul. 7943070 ( , 1979) (restrictive covenants held to constitute nonlapse restrictions).

307. See Treas. Reg. §1.83-5(a) indicating that the formula price may at times not be determinative of value but will be a substantial factor in determining value. See, also, S. Rep. No. 552, 91st Cong., 1st Sess. 121 (1969), reprinted in 1969-3 C.B. 423, 501.

308. See H.R. Rep. No. 413, 91st Cong., 1st Sess. 88 (1969), reprinted in 1969-3 C.B. 200, 255.

309. See Treas. Reg. §1.83-5(a) regarding valuation procedure.

310. See Pledger v. Comm'r, 71 T.C. 618 (1979) which sustained the validity of I.R.C. §83 against a constitutional challenge based on the definition of income in the Sixteenth Amendment as well as a Fifth Amendment due process clause claim. Cf. Eastern Service Corp. v. Comm'r, 73 T.C. 833 (1980) (resale restriction on FNMA stock to be taken into account in determining fair market value for purposes of I.R.C. §162(d) deduction for stock issued pursuant to I.R.C. §303(c)).

311. It was suggested by the Second Circuit in Sakol v. Comm'r, 574 F.2d 694 (2d Cir.) cert. denied, 439 U.S. 859 (1978) that the taxpayer in such an instance would at least be entitled to a capital loss. The capital loss theory is supported by Treas. Reg. §1.83-2(a) where a loss due to forfeiture of property, the fair market value of

which was included in income pursuant to a §83(b) election, is treated as capital if the asset is a capital asset. The loss would in any event be limited to the excess of the amount paid for the property over the amount received upon forfeiture.

312. See Treas. Reg. §1.83-1(e)

313. I.R.C. §83(e)(3). See Treas. Reg. §1.83-7. This regulation applies to all options, not just employee stock options. It was issued in 1978 shortly after I.R.C. §421 was repealed prospectively.

314. See I.R.C. §83(e)(4) and Treas. Reg. §1.83-3(a)(2).

315. I.R.C. § 83(e)(4) and Treas. Reg. §1.83-8(a)(3) specifically provide that the section does not apply to options which have no readily ascertainable fair market value.

316. See Treas. Reg. §1.83-7(a). Opting for certainty of measurement in accordance with the theory of the Supreme Court's decision in Comm'r v. Lo Bue, 351 U.S. 243 (1956) may produce more or less compensation income than was originally intended if there is a change in the stock's value between the occurrence of the two events. Cf. Treas. Reg. §1.421-6(d)(2).

317. See Rev. Proc. 81-10, 1981-1 C.B. 647 (the Internal Revenue Service will not rule on whether a transfer has occurred for I.R.C. §83 purposes if the amount paid for the purported transfer involves a non-recourse obligation). Cf. Lo Bue v. Comm'r, 28 T.C. 1317 (1957) (on remand) where it was held that the taxpayer realized income when he gave notes for the purchase of stock rather than when he paid them.

318. See Treas. Reg. §1.83-3(g) defining amount paid.

319 Treas. Reg. § 1.83-4(c) only states that the amount is includable.

320. See Treas. Reg. §1.83-1(b) and (f), Example (3). See S. Rep. No. 552, 91st Cong., 1st Sess. 122 (1969), reprinted in 1969-3 C.B. 423, 501.

321. See S. Rep. No. 552, 91st Cong., 1st Sess. 122 (1969), reprinted in 1969-3 C.B. 423, 502.

322. See Treas. Reg. §1.83-1(d).

323. See Treas. Reg. §1.83-1(c).

324. The manner of making the election is described in Treas. Reg. §1.83-2(c) (e).

325. See text at note _____, supra. See also Treas. Reg. §1.83-3(a).

326. There is an indication in the legislative history of the 1976 Tax Reform Act that Congress wanted taxpayers to be able to freely elect to be taxed at the time a stock option was granted despite the difficulty of valuing the option at that time, but no change was made in §83. See Conference Comm. Report on Tax Reform Act of 1976, Joint Explanatory Statement, S. Rep. No. 1236 [H.R. Rep. No. 94-15151], 94th Cong., 2d Sess. 438-439 (1976), reprinted in 1976-3 C.B. (Vol. 3) 807, 842-843; Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 154, reprinted in 1976-3 C.B. (Vol. 2) 1, 166, For a discussion of this method of attempting to change law, see Johnson, The Election for Compensatory Options: Dubious Use of a Conference Report for Dubious Nonlegislation, 55 Taxes 618 (1977); Pomeroy, The Metamorphosis of the Nonqualified Stock Option Under the

Tax Reform Act of 1976--the Strange Case of the Disappearing Loophole, 54 Taxes 761 (1976).

327. See Treas. Reg. §§1.83-1(a)(1) and 1.83-1(f), Example (1). This means that any dividends paid on nonvested stock will be deductible. The method for reporting such dividend items as income is set out in Rev. Proc. 80-11, 1980-1 C.B. 616.

If, however, the employee makes the 83(b) election to include the fair market value of the stock in income, dividends received on the substantially nonvested stock will be treated as dividends and will therefore not be deductible to the payor. See Rev. Rul. 83-22, I.R.B. 1983-5, at 5 and Rev. Proc. 83-38, I.R.B. 1983-22, at 21, distinguishing Rev. Proc. 80-11.

328. See Treas. Reg. §1.83-5(b)(1).

329. This same rule exists with respect to stock options under Treas. Reg. §1.421-6(f).

330. Treas. Reg. §1.83-6(d)(1) which treats a transfer of stock by a shareholder to an employee as a contribution to capital to the corporation and a deductible expense to the corporation at the proper time under §83 was presumably intended to reflect the holding in Deputy v. DuPont, 308 U.S. 488 (1940) and is supported by the section's legislative history (see S. Rep. No. 552, 91st Cong., 1st Sess. 123 (1969), reprinted in 1969-3 C.B. 423, 502). It was nonetheless struck down as "clearly outside the scope of the statutory provisions of section 83" in Tilford v. Commissioner, 75 T.C. 134, 145 (1980), but that result was reversed by the Sixth Circuit in Commissioner v. Tilford, --F.2d--, 51 A.F.T.R.2d (P-H) ¶83-1121 (6th Cir. 1983). See

also Smith v. Commissioner, 66 T.C. 622 (1976), rev'd sub nom. Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979) and Webb v. United States, 51 A.F.T.R.2d (P-H) ¶83-799 (S.D. Miss. 1983) (holding that there was a contribution to capital). Cf. Downer v. Comm'r, 48 T.C. 86 (1967).

331. See Treas. Reg. §1.83-4(b).

332. See Treas. Reg. §1.83-4(a).

333. See cases cited in note supra.

334. See Comm'r v. Flowers, 326 U.S. 465 (1946). Mr. Flowers was a lawyer employed by the Gulf, Mobile & Ohio Railroad at its main office in Mobile, Alabama. Like our hypothetical Sammy, Flowers chose to live a substantial distance from the office for personal reasons. He sought to deduct the commuting expenses between the town in which he resided and Mobile under I.R.C. §162, but the Supreme Court denied the deduction on the ground that the expense in order to be deductible must be incurred in the pursuit of business. Id. at 472. To give Sammy nontaxable income in the form of a free flight would amount to the same thing as giving Flowers the deduction he was denied.

But see O.D. 946, 4 C.B. 110 (1921) in which the Bureau held railroad passes given by employer railroads to employees to be gifts if they were not furnished in connection with the employment contract. The Service position would presumably change if the item exceeded the de minimis rule in the Proposed Regulations for employee discounts. In that event, the Service requires that the total amount for the discount be included in the employee's income. See Prop. Reg §1.61-19(c) Example (3) (ii), P-H 1983 Fed. Taxes ¶70,181 at 70,182.3.

335. See Prop. Reg. §1.61-20(c) Example (4), P-H 1983 Fed. Taxes ¶70,181 at 70,182.5.

336. For a general discussion of this concept, see Metzer Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation, 29 Tax L. Rev. 525 (1974).

337. The case that stands for the proposition that there may be some reduction in amount includable if the employee values the item less than the market does, Turner v. Comm'r, 1964 Tax Ct. Mem. Dec. (P-H) ¶64,161 (1964) suggests that another rule is more appropriate. Turner is, of course, the only case which so holds, and although there may be instances in which such a rule should apply (e.g., prizes), it is not clear why the employment relationship should be one of them. Some would accept the application of Turner in the compensation area. See N.Y. State Bar Ass'n Tax Section, Committee on Employee Benefits, Report and Recommendations on the Tax Treatment of Fringe Benefits, January 3, 1983 Tax Notes at 3, 9-10.

338. The market could be established by looking at comparative purchases, but in some instances there might be a market of one. This is essentially a matter of proof.

339. See Rudolf v. United States, 370 U.S. 269, 278 (1962) (dissent of Douglas, J. expressing concern that payment of expenses while attending convention should not constitute income).

340. See, e.g., Adolph Coors Co. v. Comm'r, 1968 Tax Ct. Mem. Dec. (P-H) ¶68,256.

341. What would undoubtedly happen in circumstances in which the employees could not pay their taxes because so much of their

compensation was furnished in kind is that employers would be forced into paying additional compensation in cash to enable the employees to meet their tax obligations. This would be accomplished either through bargaining by the employees or through market forces which would pressure the employer into making such cash payments in order to keep a work force.

The current opposition of the Treasury is that the "perceived hardship" for employees who receive in kind compensation is too great to require the employee to pay the tax on the fair market value of an item of in-kind compensation. Instead, the Treasury has proposed that there be an excise tax levied on employers (or, as an alternative, that the business expense deduction for in-kind payments be disallowed) on the value (allocated cost plus a fair return on that cost) of the fringe benefits provided in kind. See Chapoton statement, June 27, 1983 Tax Notes at 1193 [Hearings].

The alternative suggested here would also tend to be directed to having the employer bear more of the burden of taxation if the in-kind method of compensation is chosen, but the focus on the employer would be less direct than in the solution suggested by the Treasury. In addition, the clearly appropriate measure of the amount of compensation to be accounted for is the fair market value of the item, and the Treasury's proposal simply fails to use that measure in its reliance on cost plus fair return. The Treasury's method, proposed in part for its simplicity, of taxing fringes is no easier than the method proposed here.

342. See I.R.C. §72, discussed generally in Bittker, supra note ___ at ¶12.3.

343. See Internal Revenue Act of 1939 ch. 2, §22(b) (2), 53 Stat. 1, 8.

344. See Prop. Reg. §1.61-18(a) P-H 1983 Fed. Taxes ¶70,181 at 70,182.1 defining "working condition." For further definitions, see authorities cited in note , supra.

345. The proposal here is at odds with the "working condition fringe" exclusion in H.R. 3525 which would allow an exclusion for the entire value of an automobile so long as it were "provided primarily for the purpose of facilitating the employee's performance of service for the employer and substantially all of the use of the property" would be in connection with the performance of services. See proposed §132(d).

346. See ABA Legislative Recommendation, supra note . Proposed §128(d) specifically refers to recreational benefits. Cf. Rev. Rul. 79-360, 1979-2 C.B. 236 and Ltr. Rul. 8323074 (March 10, 1983) (recreational facilities and a general fitness program made available to employees do not affect the exempt status of a §501(c) (3) organization).

347. Cf. proposed §280F. An analysis of recreational benefits provided by employers and the need to distinguish among them on the basis of the type of benefit may be found in Guttentag, Specific Proposal, supra note at 266-268. The suggestion made there that there should be a distinction between relatively small benefits and larger ones on the basis of whether the employer provides overnight accommodations makes a good deal of sense. In addition, as there noted,

there would need to be a nondiscrimination rule in this context so that large benefits made available only to executives would be taxed to them.

348. See proposed §132(b) and (c).

349. See Prop. Reg. §1.61-19, P-H 1983 Fed. Taxes ¶70,181 at 70,182.2.

350. See Prop. Reg. §1.61-19(b) (2), P-H 1983 Fed. Taxes ¶70,181 at 70,182.3.

351. See generally, Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U.Pa. L. Rev. 47 (1977).

332. See Steuerle, A Primer on the Efficient Valuation of Fringe Benefits, Office of Tax Analysis, U.S. Treasury Dept., OTA Paper 51 (1982).

353. See N.Y. State Bar Report supra note at 6-7.

354. It has been suggested that the appropriate measure of the inclusion should be marginal cost plus opportunity cost because that is the most efficient valuation of fringes. See Steuerle, supra note 337 at 21 ff. The theory demonstrated by Steuerle is certainly a more compelling one than other suggestions that the measure of the amount includable should be limited to the employer's allocated per employee cost. See, e.g., N.Y. State Bar Report, supra note at 6-7. The proposal has been criticized because the allocated cost figure proposed there would actually tax a greater amount to the employee than would incremental cost. See letter of Sol Coffino, President of the Tax Executives Institute (TEI) to Roscoe Egger, then Commissioner of Internal Revenue, dated November 1, 1982, quoted in January 3, 1983 Tax Notes at 12, 13. The letter refers to the position taken by the AICPA

in the proposal that it advanced in 1979, "Fringe Benefits: A Proposal for the Future," in which it was suggested that the measure be incremental cost.

See also, Nolan, Taxation of Fringe Benefits, 30 Nat'l Tax J. 359, 362 (1977) (advocating fair market value as the appropriate measure); Chapoton testimony, supra note at 1193 (suggesting that "fair market value" is too difficult to determine, and, as an alternative, proposing an excise tax on employers or disallowance of employer business expense deductions for fringes, in either case using as value allocated cost plus a fair return on that cost). Cf. United States v. Basye, 410 U.S. 441, reh. den. 411 U.S. 940 (1973) (members of a medical partnership currently taxable on amounts contributed to nonqualified plan by an organization for which the partnership performed medical services under contract; it was irrelevant that the partners might never have received the amounts contributed in their names).

355. See text at note supra.

356. See text at note supra.

357. To the extent that the beneficiary receives amounts in excess of the employee's contributions (on the assumption that the earnings of the invested plan contributions are not taxed currently to the employee whose rights to them have vested, a not altogether proper result from a policy standpoint), those amounts would be taxable to the extent they exceed the basis generated by the prior inclusion in income. The reason for this result is the general notion of cost recovery. While it is true that the rule suggested here does not assign the cost to the proper party, it is similar to the rule in the gift area prescribed by §1015 basis. In addition, there seems to be no alternative other than double taxation.

GEORGETOWN, KY., *August 10, 1983.*

Mr. JOHN J. SALMON,
*Chief Counsel, Committee on Ways and Means,*
*U.S. House of Representatives, Washington, D.C.*

DEAR MR. SALMON: I wish to submit the following statement for consideration by the House Ways and Means Committee in their deliberations upon H.R. 3525.

I am writing to your committee as a parent and as a former teacher to express my hope and concern that H.R. 3525 now before the Ways and Means Committee will extend to all college tuition remission programs recognition as scholarships and protection from taxation. Such programs have served the schools and scholars of this country well for many years and have provided an educational lifeline to many young people. I am thankful that tuition remission programs at the home institution are already being recognized—as they have been interpreted under past IRS codes—as scholarships exempt from taxation. But I ask that the committee consider the following points before restricting such aid to the home institution:

1. No college—or individual—profits from excessive inbreeding. Accreditation boards, such as the Southern Association of Colleges and Universities, recognize this point in requiring a substantital proportion of an institution's faculty to hold degrees from schools outside the immediate region. Colleges recognize this point in trying to recruit students with varied backgrounds. The different experiences, viewpoints and beliefs brought together thus are the elements that spark the exchange of ideas and breathe life into an institution. Tuition exchange programs with other institutions are one way a college recruits outside students.

2. The same insularity can smother a student. Many schools offering tuition remission programs are small, self-contained academic communities where faculty and students often meet outside of class. Faculty families usually find their social life within the same circle. Such informal familiarity facilitates the exchange of ideas and is one of the attractions of smaller institutions. But for a student who has grown up among these same professors, an education on the home campus will lack the excitement and stimulation that a college education should provide. Tuition exchange programs student as they are to the institution.

3. Off-campus tuition exchange programs are a form of scholarship offered only to qualified students. Most schools limit the number of students they will accept under such a program and offer the tuition remission only to their best applicants. The acceptance is based upon the student's performance and promise—not upon the parent's standing at the home institution.

4. Tuition exchange programs, like other scholarship offers, go directly to the student, not to the parent. It has always been the student and not the parent who is recognized as the recipient of college aid, including that from the government. It is the student who receives the grant or scholarship or loan and it is the student who is obligated to repay the loan, just as it is the student—and not the parent—who will benefit from the education received. Parents have never been taxed for educational opportunities offered to their children.

5. Tuition exchange programs are no different in principle from other scholarship programs which limit the pool of their recipients to a particular subgroup. Many of the National Merit Scholarships, for example, are contributed by private corporations who specify that the recipents must be children of company employees. In all such cases, however, it is the student—and not the employed parent—who benefits. Such scholarships in no way affect the terms or length of the parent's employment, nor are they offered as a reward for employees performance. In the case of off-campus tuition exchange programs, the parent is not even an employee of the host school.

6. Many of the students attending school on tuition remission programs are from families of modest income, families who have chosen to dedicate themselves to an institution of limited means. In such cases a tax on the tuition remitted would place the programs out of reach (though perhaps, in true bureaucratic fashion, we might eventually have government grants for needy students to cover tuition taxes). For a student who needs to be away from home not only for intellectual development, but also for emotional development, the lost educational opportunity would be a great personal loss. And for the nation that needs to see its young people reach their fullest potential, it would also be a great loss.

As a parent, I cannot understand the priorities of a nation that, in an age when education is particularly vital to the national interest, would make education so difficult to obtain that it even considers taxing tuition benefits. I cannot understand tax laws that reward us for financial mismanagement by encouraging us to go into debt, but which would punish us for accepting an educational opportunity. I cannot understand governmental philosophies which promote the public dole as the major source of college funds through grants and loans, but which would sharply restrict the aid available directly from schools. In the final analysis, I cannot even understand why tuition payments are not considered as tax deductions. Surely it is as important to the future of our nation to encourage the education of our youth as it is to encourage energy conservation or charitable contributions, and perhaps even more intrinsic to our national stability than encouraging consumer debt and political contributions.

There surely must be many parents like myself who ask not for public grants or loans, but simply for a chance to turn our children into productive, enlightened citizens. In the name of all that is sane and just, please do not cut off any avenues that enable us as parents to adopt the education we offer our children to their needs. In return, I think we can promise you young people who will be a credit to our nation.

Sincerely,

ELIZABETH K. WILLIAMS.

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